

# Paying Back Your Country Through Income-Contingent Student Loans

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*Governmental subsidies to higher education raise issues of fairness between families and between generations. The recent partial conversion of the federal guaranteed student loan program into a program of direct governmental lending permits a graduate to pay back the loan with a modest percentage of future income. This income-contingent repayment option provides most graduates with the only insurance they need against a poor job market. Thus, the new legislation needlessly retains existing federal subsidies, which could be more effectively targeted to the needy.*

All the world's a stage,  
And all the men and women merely players;  
They have their exits and their entrances,  
And one man in his time plays many parts,  
His acts being seven ages.<sup>1</sup>

Then, in just seven sentences, Shakespeare takes us from mewling infancy to the whining schoolboy, the sighing lover, the brave soldier, and the wise justice, before concluding with shrunken old age and second childhood and oblivion. Such an abbreviated recital must necessarily omit a bit player who creeps step by step alongside each actor — sometimes giving, sometimes taking — ensuring that at each age the players remember their bonds with one another. This is,

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1. WILLIAM SHAKESPEARE, AS YOU LIKE IT act 2, sc. 7.

of course, the government. Unfortunately, these days we employ less poetic, more business-like terms. The Seven Ages of Man has become the "life cycle." Economists call the financial arrangement between citizens and government "public finance."

But just as each man and woman over time plays many parts, so too does the public finance system. The government performs not just tax collection, but also makes transfer payments (those dreaded "entitlements"<sup>2</sup>) as well as incurs direct expenditures. From the cradle to the grave, tax and other collective finance policies aid or hinder our major personal decisions.<sup>3</sup> When we are young and when we are old the government makes net transfers to us — think public schools; think Social Security and Medicare. In between, while we might benefit economically from some governmental programs, most of us make net transfers to the government. And while our individual lives course the seven ages, our society as a whole must be self-contained. Where the government gives more than it takes, the deficit spending creates a ripple effect sideways to contemporaneous capital markets and, if the current generation fails to invest these transfer payments in physical or human capital, downstream to future generations.

Whenever society collects ("taxes") and provides ("spends"), it creates redistributive effects. Often the decisions about how to tax and how to spend have no necessary relationship with each other. We might, for example, decide on a progressive income tax as a mechanism to finance a navy that protects all residents equally. Much governmental activity is not, however, aimed at providing these types of public goods. Some governmental programs, such as welfare programs, deliberately seek to transfer resources from the rich to the poor. Commonly, policies largely make winners and losers out of people in the same economic stratum, such as public elementary and secondary schools financed from local property taxes. Aside from whether redistributive public spending is efficient (a matter of positive economics), government redistribution of wealth from poor to rich, or even from one middle-class citizen to another, is often perceived as not being fair (a matter of normative economics). But even if we agree that we wish to transfer resources in a certain way, it is often difficult to figure out the distributive consequences

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2. "Entitlements truly are the third rail of politics." Michael Arndt & Elaine S. Povich, *Budget Package "Cuts" Are Deceptive*, CHI. TRIB., June 18, 1993, § 1, at 6 (explaining that "Medicare and Social Security . . . programs, which now consume 53 percent of the entire federal budget, have broad and powerful constituencies").

3. Professor David Bradford defends using the tax code as a mechanism to carry out social programs because such a large percentage of the population must already make an annual filing. "Perhaps we would view April 15 differently if we called it the 'annual unified individual tax and subsidy' filing date." DAVID F. BRADFORD, *UNTANGLING THE INCOME TAX* 270 (1986).

of a particular program.

For example, to ensure the development of human capital, such as education, most private citizens do not really need outright governmental subsidies.<sup>4</sup> That is, children and healthy and educated citizens are not in themselves public goods, because the benefits to the parents or to educated or healthy people outweigh the costs to those individuals.<sup>5</sup> Yet as individuals we often find ourselves constrained from making optimal expenditures on children, education, and health care. This is generally because the expenditure arises before we have earned the income to pay for it. Although it is well recognized that lifetime expenditure requirements follow a more level curve than does our income stream, the private market will not generally lend against future earnings.<sup>6</sup> Thus, in many of these cases the proper role of the government might be to remedy "market failure" — to facilitate loans for investments in human capital.

This article focuses on the college student, who incurs expenses that he or she probably only vaguely associates with an economic payoff. Who should bear the burden of these costs? Some argue that society as a whole should pay, because democracy is strengthened when all can reach their intellectual potential. Others argue that the family should pay, because the family can "capture" the financial rewards. Even those who would impose the cost on the family debate over which generation should pay: the parents, because *their* parents put them through school, or the student, because the human capital investment will produce an ample income stream to satisfy the costs.

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4. This article does not explore how differing constituencies obtain government benefits at the expense of other groups. See, e.g., Daniel Shaviro, *Beyond Public Choice and Public Interest: A Study of the Legislative Process as Illustrated by Tax Legislation in the 1980s*, 139 U. PA. L. REV. 1 (1990).

5. See, e.g., William H. Oakland, *Theory of Public Goods*, in 2 HANDBOOK OF PUBLIC ECONOMICS 485, 498-99 (Alan J. Auerbach & Martin Feldstein eds., 1987) (distinguishing "public goods," which no one can consume to the exclusion of others' enjoyment, from "externality goods," which individuals generally have an incentive to provide from their own resources because they can consume a significant portion of the total benefits from consumption).

6. Compare, e.g., Stephen P. Zeldes, *Consumption and Liquidity Constraints: An Empirical Investigation*, 97 J. POL. ECON. 305 (1989) (suggesting that an inability to borrow against future income constrains the consumption of a significant portion of the population) with Janet S. Hansen, *STUDENT LOANS: ARE THEY OVERBURDENING A GENERATION?* 33 (1986) (research report prepared for the Joint Economic Committee of the U.S. Congress, on file with author) (because of unsecured credit cards, "borrowers appeared to be able to obtain 'huge' amounts of consumer credit; their own self-imposed limits were responsible for keeping debt levels generally below maximum levels established by the marketplace"). With its generally high interest rates, credit card debt is suitable only for short-term expenditures. See *infra* text accompanying note 167.

Finally, many agree that as a matter of fairness society should continue to bear costs for financially needy students. How — or when — do we separate those deserving of outright grants from those who just need a loan? In short, how much of higher education should society pay for, and how well can it target the desired subsidies?

The first part of this article lays the framework for analyzing when an individual needs a handout and when he or she merely needs a hand to obtain a college education. We begin by separating “public” from “private” goods; focusing on who benefits from higher education, we see that a college education is clearly profitable for the family even without government subsidy. Interfamily equity, then, generally argues for making each family responsible for the education of its own members.

Turning next to intergenerational fairness, we learn that one cannot assume simply by looking at who makes the nominal tuition payment or loan repayment (or who nominally receives income) that a particular family member or generation bears the financial burden of an educational expenditure (or enjoys the benefit of an enhanced income stream). Thus, we can neither hope to “impose” financial costs on either parent or child, nor deprive one or the other of the financial rewards of an education, because the members can make compensating intrafamily transfers. The same is true within society as a whole, as the debate over deficit financing attests, thus questioning whether a shift in education aid from a program of grants to a program of loans effectively shifts costs from the current taxpaying generations to later ones.

Next we focus on determining a particular student’s (or family’s) financial well-being, which we need to know in order to assess worthiness for any governmental subsidies we wish to provide. Because the government routinely measures its citizens’ resources on April 15, this determination begins with tax policy. We discover, however, that our tax rules often arbitrarily distinguish between the resources of one individual (such as the child) and the resources of a broader economic unit (such as the family). Moreover, we see that the resources of the same person change as she moves through her life cycle of income and consumption. Specifically, income tends to rise with age, peaking in middle age before falling off after retirement, but consumption tends to be more level. Thus a person can look financially deserving when young regardless of whether over her lifetime she turns out to be quite financially comfortable.

We conclude Part I with a review of the economic basis for the current tax rules applicable to investments in education. As academics have long complained, to the extent higher education can be shown to generate profits rather than to supply personal consumption, we actually overtax college costs compared with other business

investments by denying any cost recovery and interest deductions for these expenditures. Moreover, using the tax system alone to effect transfers is overly generous to some individuals and less than helpful to others. "Tax expenditures" in the form of deductions (Stanley Surrey's "upside-down" subsidies) provide the most value to those in the highest tax brackets, who surely need help the least.<sup>7</sup> Yet, we do not have a negative income tax, and so a tax subsidy (whether in the form of a deduction or a credit) provides no cash benefit greater than the individual's current tax liability.<sup>8</sup>

Accordingly, the second part of the article turns to a specific governmental program for making uniform resources available to all college students, with the least effective redistribution: loans. The student loan program appears to be precisely the governmental tool we seek — it operates not as a transfer program but as a mechanism to smooth life cycle investment in a generally profitable activity for which the private sector nevertheless will not freely lend. The federal government has offered student loans in some form since Sputnik, and guaranteed student loans currently represent the largest federal aid program for higher education. The federal government uses a student's, and her family's, financial status in pegging varying levels of interest subsidies to borrowers (in addition to conducting its dwindling needs-based grant program). In the Omnibus Budget Reconciliation Act of 1993 ("OBRA 1993")<sup>9</sup> Congress enacted President Clinton's student loan reform package, which includes a feature that permits graduates to repay their debt out of a modest percentage of future income.<sup>10</sup>

With the framework we established in the first part of this article, we see that the federal student loan program makes a good start in facilitating college attendance. However, if you believe as a normative matter, as I do, that we should transfer resources to those at the

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7. STANLEY S. SURREY & PAUL R. MCDANIEL, TAX EXPENDITURES 71-82 (1985).

8. The only refundable tax credit is the earned income tax credit ("EITC") for low-income working parents. I.R.C. § 32 (West Supp. 1994). [Unless otherwise indicated, all statutory citations are to the Internal Revenue Code of 1986, as amended 26 U.S.C.A. §§ 1-9722 (West 1988-1989 & Supp. 1994).] Congress recently extended the EITC, in reduced form, to childless workers between the ages of 25 and 65. I.R.C. § 32(c)(1)(A)(ii), *amended by* Omnibus Budget Reconciliation Act of 1993, Pub. L. 103-66, § 13131(b), 107 Stat. 312, 434 (1993) [hereinafter OBRA 1993].

9. OBRA 1993, *supra* note 8, Title IV.

10. I conclude Part II with discussions of the administrative issues raised by converting the current guaranteed student loan program to one of direct federal lending, and by proposals to have the Internal Revenue Service participate in collecting loans repaid under the income-contingent method.

bottom of society's economic distribution, but not to those at the middle or upper levels, then our current backwards-looking financial aid tests, based on the resources of the student and his parents, understates the ability of the family to bear the costs of a college education. A snapshot analysis of financial need causes us to oversubsidize those who have simply not started their own routine lifetime climb to financial security. Needs-based grants and loan subsidies lump together those who are chronically needy with those who seem needy only because of their current position on the life cycle.

President Clinton's reform package leaves in place all the interest rate subsidies for borrowers that existed in prior law. Moreover, in contrast to Yale University's income-contingent loan experiment in the 1970's, Clinton's program is not "mutualized." Accordingly, taxpayers in general rather than other borrowers subsidize a particular debtor electing income-contingent repayment who chooses a career that will not be (or turns out not to be) financially profitable. However, this very option of income-contingent repayment suggests that it would not necessarily be unfair to impose an unsubsidized loan on a currently low-income young college graduate. That is, we could (and I believe should) charge market interest rates<sup>11</sup> to all but those most disadvantaged, because income-contingent repayment is the only insurance most borrowers need. After all, unless the cost can effectively be shifted to later generations, our middle-class citizens had better, over their lifetimes, come up with sufficient resources to finance (at least) all of their expenditures. Because we fail to realize that the problem is really one of timing, we continue to devote too much of our limited collective resources to those who eventually can easily foot the bill, while depriving those who really need the boost.<sup>12</sup>

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11. Cf. D. Bruce Johnstone, *International Perspectives: A Five-Nation Study*, in *STUDENT LOANS: RISKS AND REALITIES* 89, 97 (Joseph M. Cronin & Sylvia Q. Simmons eds., 1987). Johnstone writes:

I do not think that there exists an interest rate high enough to carry a truly unsubsidized student loan plan available to all students without collateral or credit checks or risk-rating. . . . The international perspective underscores the usefulness of a loan program that is subsidized enough to be accessible and not overly burdensome, yet also so sufficiently unsubsidized to undergird that share of costs deemed appropriate to be borne by students without the fear of its being misused and converted to cheap capital by the non-needy family.

*Id.*

12. See, e.g., Neil Howe & Phillip Longman, *The Next New Deal: Federal Entitlement Reform*, *ATLANTIC MONTHLY*, Apr. 1992, at 88, 90 (Congressional Budget Office research demonstrates that "the most affluent Americans actually collect slightly more from the welfare state than do the poorest Americans. . . . Quite simply, if the federal government wanted to flatten the nation's income distribution, it would do better to mail all its checks to random addresses.").

## PART I: THE LIFE CYCLE TREATMENT OF HUMAN CAPITAL INVESTMENT

### A. Who Benefits from a College Education?

A college degree serves as the main portal to the great American dream of a secure financial future. While we might perhaps suffer from an oversupply of college graduates (as opposed to those who might be better off trained in the vocational arts),<sup>13</sup> the public views access to a college education for all as a pillar of our egalitarian society.<sup>14</sup> A concerned populace, therefore, shudders at the ever-rising costs of higher education, which seemingly price all but the rich or scholarship recipients out of the market.<sup>15</sup> The middle-class has

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13. See, e.g., Ray Marshall & Marc Tucker, *Building a Smarter Work Force*, TECH. REV., Oct. 1992, at 52, excerpted in *Vocational Education: High-Skill Employees*, CURRENT, Mar.-Apr. 1993, at 17, 17 ("The economic future of the United States depends mainly on the skills of the front-line work force, the people whose jobs will not require a baccalaureate degree."). Politicians from both parties support federal aid for school-to-workplace training for the 50% of young people who do not go on to college (and the half of those who do not obtain a college degree). See, e.g., President William J. Clinton, Remarks to the National Association of Counties by Satellite from the White House (July 19, 1993), available in LEXIS, NEWS Library, FEDNEW File ("And for the majority who don't attend college, we funded the boldest national apprenticeship program ever."); *House Republicans Introduce School-to-Work Transition Bill Calling for Voluntary Standards*, DAILY LAB. REP. Mar. 25, 1993, at A1; *Reich and Riley Sketch Broad Outlines of U.S. School-to-Work Transition System*, DAILY LAB. REP. Feb. 23, 1993, at A11. "The United States is the only major industrialized nation that lacks a formal system for helping youths make the transition from school to work. . . ." National School-to-Work Transition and Youth Apprenticeship Act of 1993, H.R. 1454, 103d Cong., 1st Sess. § 3(5) (1993). "[T]he United States educational system continues to be geared disproportionately toward meeting the needs of college-bound students." *Id.* § 3(6). "[I]n Germany, almost all eligible students apply for vocational training, which substantially reduces the risk of unemployment for young people. . . ." Youth Apprenticeship Act of 1993, H.R. 1112, 103d Cong., 1st Sess. § 2(a)(2) (1993). "[A]bout 9,000,000 of the 33,000,000 United States youth age 16 to 24, or 27 percent of the youth, lack the necessary skills to meet employer requirements for entry level positions." *Id.* § 2(a)(7); see Career Pathways Act of 1993, S. 456, 103d Cong., 1st Sess. (1993); see also Goals 2000: Educate America Act, Pub. L. No. 103-227, 108 Stat. 125 (1994).

14. NATIONAL COMM'N ON RESPONSIBILITIES FOR FIN. POSTSECONDARY EDUC., MAKING COLLEGE AFFORDABLE AGAIN, at x (1993). But see, e.g., Peter Schrag, *Who Pays for College?*, SACRAMENTO BEE, Dec. 2, 1992, at B8 ("We have slowly persuaded ourselves that everybody is entitled to go to some 'college' somewhere. No other society has ever embraced such a radical idea."). Urban Institute Senior Fellow Isabel Sawhill believes that government subsidies for expenditures in human capital, including on-the-job training, "improve social mobility and benefit society's have-nots," as opposed to physical capital subsidies, which tend to go to the already wealthy." J. Andrew Hoerner, *Enact Wide Range of Programs, Urges Urban Institute's Sawhill*, TAX NOTES TODAY, Oct. 11, 1991, available in LEXIS, FEDTAX Library, TNT File as 91 TNT 211-9.

15. See, e.g., News Conference, NATIONAL COMM'N ON RESPONSIBILITIES FOR FIN. POST-SECONDARY EDUC., Subject: Release of the Commission's Report on Financing Higher Education, Feb. 3, 1993, available in LEXIS, NEWS Library, FEDNEW File

long clamored for more governmental assistance, especially federal assistance.

Our nation is better off by having a well-educated populace.<sup>16</sup> This does not necessarily mean, however, that government should bear the costs of providing higher education to its young people. Some argue that the government should pay for all costs of college because the resulting increased earnings will more than compensate the fisc through higher tax revenues.<sup>17</sup> However, where the individual students would obtain a college education without a subsidy, it would be inefficient for government to provide one; nor would it be fair for all taxpayers to send the children of the upper classes to college.<sup>18</sup>

We know that the "diploma premium" is real. The Commerce Department recently found that on average a college graduate earns nearly *twice* as much as a high school graduate.<sup>19</sup> In examining who

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(quoting Rep. Steve Gunderson) ("I mean, we're here because we know that the sons and daughters of America cannot get into college right now unless they are terribly poor or terribly rich. . . .").

16. See, e.g., *Survey of Education: Human Capital*, ECONOMIST, Nov. 21, 1992, at 4, 5 (Special Supp. located after p. 64) [hereinafter *Human Capital*] (Education has become such an important asset in rich countries because of "globalisation and automation. Globalisation means that many low-value-adding jobs are exported to poorer and cheaper countries. Automation means that jobs that stay in rich countries are increasingly done by machines. . . . You need intelligent workers to get the most out of intelligent machines.").

17. See, e.g., John F. Morse, *How We Got Here from There — A Personal Reminiscence of the Early Days*, in STUDENT LOANS: PROBLEMS AND POLICY ALTERNATIVES 3, 4 (Lois D. Rice ed., 1977) ("Senator [Wayne] Morse loved to provide graphs and charts showing that increased tax revenues from enhanced earning power repaid the national investment many times over.").

18. See, e.g., *Survey of Education: Making It Work*, ECONOMIST, Nov. 21, 1992, at 16, 17 (Special Supp. located after p. 64) ("Governments spend too much on people who are predestined for educational success and too little on people who are prone to educational failure. . . . [I]f you want big returns on educational expenditure, invest in the youngest."). England is currently engaged in the debate over whether to shift higher education costs to students and their parents:

Many parents are infuriated by the suggestion that they or their offspring will have to pay for the kind of student life that was accepted in their day as a liberating right. . . .

But this "liberation" is really only a feature of our middle-class society: children from professional/managerial backgrounds are still four times more likely to go to university than their working-class contemporaries.

Colin Hughes, *Why Students Must Learn to Pay; Those Who Gain Most from Higher Education Should Contribute More*, INDEPENDENT, July 21, 1993, at 22.

19. In just seven years, the percentage of American adults with a "degree beyond high school" leapt from one-in-five to one-in-four (from 20.7% in 1984 to 25.2% in 1990). REBECCA SUTTERLIN, COMMERCE DEP'T, PUB. NO. P-70-32 WHAT'S IT WORTH? EDUCATIONAL BACKGROUND AND ECONOMIC STATUS: SPRING 1990 (1993). Based on data from the Census Bureau's Survey of Income and Program Participation (SIPP), Ms. Sutterlin determined average monthly earnings for the following educational levels:

Doctorate	\$3,855
Professional	4,961
Master's	2,822
Bachelor's	2,116
Associate	1,672



gained from the expanding economy in the 1980s, we find that it was the college-educated who pulled away from the pack.<sup>20</sup> A diploma generally pays off quickly,<sup>21</sup> and keeps paying off at an accelerated rate.<sup>22</sup>

Society should properly subsidize the cost if the public would be better off by a particular student's choice of education but the human capital investment would not be "profitable" for her.<sup>23</sup> First, though, if the market inadequately compensates certain workers, we should examine why salaries do not simply rise. The answer might be, in many cases, that the compensation package is partially non-monetary. Artists generally don't have to punch a clock; ministers can be admired for doing good. We do not include psychic income in the national income and products accounts, but it is real, and factors into a calculation to enter a particular field. Even if we believed that

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Vocational	1,237
Some college, no degree	1,280
High school graduate	1,077
Not a high school graduate	492

*Id.*; See also Robert M. Hauser, *Trends in College Entry among Whites, Blacks, and Hispanics*, in STUDIES OF SUPPLY AND DEMAND IN HIGHER EDUCATION 61 (Charles T. Clotfelter & Michael Rothschild eds., 1993); Kevin Murphy & Finis Welch, *Wage Premiums for College Graduates: Recent Growth and Possible Explanations*, 18 EDUC. RESEARCHER 17 (1989).

20. See, e.g., NATIONAL CTR. FOR EDUC. STATISTICS, U.S. DEP'T OF EDUC., THE CONDITION OF EDUCATION 1992, at 84 (1992) (comparing 1980 and 1990, the earnings advantage increased about 23% for white college graduates and about 28% for black college graduates) (calculations by author); W. Norton Grubb, *The Varied Economic Returns to Postsecondary Education: New Evidence from the Class of 1972*, 28 J. HUM. RESOURCES 365 (1993) (fundamental difference between the labor markets for college graduates and for those with sub-baccalaureate education); Daniel E. Hecker, *Reconciling Conflicting Data on Jobs for College Graduates*, MONTHLY LAB. REV., July 1992, at 3 ("relative earnings increase for college graduates was the result of a worsening job market for male high school graduates, not because of a shortage of workers with college degrees").

21. See, e.g., *College Dividend: Diploma is Worth \$1,039 Extra a Month*, CHI. TRIB., Jan. 28, 1993, at N5 (explaining Census Bureau data: "At that rate, and not taking taxes into account, it takes the typical four-year graduate just a little under two years after getting out of school to accumulate enough of the extra pay to cover his or her tuition bill.").

22. See, e.g., *Human Capital*, *supra* note 16, at 4 ("Educational success in youth seems to pay mounting dividends in maturity. . . . [U]niversity graduates . . . discover that each step upwards is increasingly remunerative. . . . [T]he well-educated land jobs that provide them with more training, while the uneducated are locked out of opportunities to improve their skills.").

23. Additionally, government might properly subsidize on-the-job training, because firms cannot always capture the full value of training: an employee could simply move to another employer. See, e.g., Hoerner, *supra* note 14.

we do not have enough artists, social workers, or ministers, the solution is not necessarily for the government to finance the education of students in these fields. If anything, subsidizing inputs is a crude way to stimulate the production of outputs. That is, paying for a nineteen-year-old's college major in the hopes that the graduate will pursue that field, and continue to for the next forty years,<sup>24</sup> is far less efficient than for the government to, say, buy works of art or reimburse favored uses of social services.<sup>25</sup> If anything, the government should encourage the dissemination of accurate information about payoffs to various forms of education.<sup>26</sup>

### B. Intergenerational vs. Interfamily Warfare

Will the millennium in the United States be marked by a final break between the generations? With "serial fathers," deadbeat

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24. Cf. Charlotte V. Kuh, *Comment*, in STUDIES OF SUPPLY AND DEMAND IN HIGHER EDUCATION, *supra* note 19, at 179, 181 (response to Jerry R. Green, *Future Graduate Study and Academic Careers*, in STUDIES OF SUPPLY AND DEMAND IN HIGHER EDUCATION, *supra* note 19, at 145) ("One thing that I have found striking for my own class of Radcliffe women is how few of us are now doing what we planned to do on graduation.").

25. The Constitution prevents the government from purchasing religious outputs, but the federal government provides large input subsidies to the religious sector through tax exemption for churches (I.R.C. § 501(c)(3)), income tax exemption for parsonage allowances (I.R.C. § 107), and (for those who itemize their tax deductions) deductibility of donations to churches (I.R.C. § 170).

26. See, e.g., *Address by President-Elect Bill Clinton at Wilbur Wright Community College, Chicago, Illinois*, Dec. 7, 1992, available in LEXIS, NEWS Library, FEDNEW File ("[W]hat we really need to do . . . is to make sure that none of you are being defrauded in America. That . . . we should have enough information — honest, good, reliable information — to tell you what the prospects are on the other end, what the demand is"); cf. Jayne de la Huerza, *Misled Student?*, CHI. TRIB., Nov. 26, 1992, at C26 (letter to the editor) ("If there be a moral to this story, it is for the student to research future employment trends before committing oneself to a major. With a surfeit of tenured professors, don't ever expect the universities to give you the straight dope on anything — least of all employment opportunities."). But see Kenneth J. Cooper, *Questioning the Need to Repay School Loans; Judge Says State Law May Free Students of Obligation When Training Is Inadequate*, WASH. POST, July 22, 1991, at A9 (reporting on preliminary ruling by West Virginia district court against Northeastern Business College); *Clinton Signs Education Act Technical Bill with No New Student Loan Bank Suits*, DAILY REP. EXECUTIVES, Dec. 21, 1993, at A243, available in LEXIS, NEWS Library, DREXEC File (the Higher Education Technical Amendments of 1993, Pub. L. 103-208, 107 Stat. 2457, was passed without a Senate amendment to allow borrowers to sue lenders for refund of loans repaid if the student was misled into paying for an inadequate education — effectively, students still have such a remedy if they attend a proprietary institution but not if they attend a nonprofit one); see also *Student Loans: DoEd Report Scrutinizes Trade Schools*, DAILY REP. CARD, July 19, 1993, available in LEXIS, NEWS Library, RPTCRD File (explaining that because of high default rates at proprietary schools, the government winds up spending thousands of dollars per student to train cosmetologists, security guards, court stenographers, computer technicians, medical assistants, and truck drivers, despite the glutted job market in these fields). See generally Charles F. Manski, *Adolescent Econometricians: How Do Youths Infer the Returns to Schooling?*, in STUDIES OF SUPPLY AND DEMAND IN HIGHER EDUCATION, *supra* note 19, at 43.

dads, and increasing proportions of children born to single mothers, many children lose all or most ties to half of their progenitors.<sup>27</sup> At the same time, the Gray Lobby puts visible, increasing financial burdens on their working children and those not yet born — pressure that might lead to a rebellion against perceived golf-cart grannies,<sup>28</sup> who retire earlier, live longer, and have a lower percentage of poverty than households with children.<sup>29</sup> In the midst of this, federal support for the greatest legacy parents can give their kids — a college education — shifts from a system of grants to a system of loans, saddling those entering the workforce with up to tens of thousands of dollars of debt.

27. See, e.g., Dennis A. Ahlburg & Carol J. De Vita, *New Realities of the American Family*, POPULATION BULL., Aug. 1992, at 2, 4 (stating that about half of children will live with only one parent before age 18).

28. The twentysomethings have formed groups such as "Lead or Leave" (whose advisory board cochairman is Paul Tsongas) to assert clout against the American Association of Retired Persons ("AARP") and others whom they feel have mortgaged their future. See, e.g., Heather A. Hope, *Youth Advocacy Group Protests Federal Deficit*, TAX NOTES TODAY, July 15, 1993, available in LEXIS, FEDTAX Library, TNT File as 93 TNT 148-7; Jeff Kunerth, *Generations Do Battle Over Social Security*, Hous. CHRON., May 9, 1993, at A10 ("With 34 million members — half the nation's elderly — the AARP is the 800-pound gorilla of Washington, D.C. . . . Representing 12 percent of the population, the AARP's constituency commands 30 cents of every dollar spent by the federal government"). The satiric troupe, Capitol Steps, sings the following lyrics to the Crosby, Stills & Nash tune of "Teach Your Children Well" (which they call "Tax Our Children Well"):

We who are old and gray will make you pay so we'll be set up.

Or else we'll stay in town; she just fell down, and (she) can't get up.

It's you we're living off, so we can golf and buy our dentures.

Politicians who ask why, we pulverize and fry, while we bleed you yuppies dry

— because we love you.

Thomas J. Brazaitis & Michelle R. Washington, *Busters vs. Geezers; Young Want Cuts in Social Security*, CLEV. PLAIN DEALER, Mar. 21, 1993, at C1; cf. Charles Laurence, *Our Parents Trashed the Nation's Institutions, Leaving Us to Wade Through the Flotsam. We Will Suffer Lower Living Standards Because They Borrowed Money*, DAILY TELEGRAPH, May 11, 1993, at 17 (nor are the Baby Boomers safe from the wrath of younger adults; quoting Robert Lukefahr, age 29: "Let's start at their finest hour, Woodstock. . . . Few of the attendees purchased tickets; most simply crashed the fence as if it were some sort of birthright. Three days later, the farm lay in ruins. . . . Boomers declared the concert a triumph and left the mess for those who followed behind."). See generally DOUGLAS COUPLAND, *GENERATION X: TALES OF AN ACCELERATED CULTURE* (1990) (a statistic-laden novel).

29. Murray Gendell & Jacob S. Siegel, *Trends in Retirement Age by Sex, 1950-2005*, MONTHLY LAB. REV., July 1992, at 22; Howe & Longman, *supra* note 12, at 95 (stating that in 1969, 25% of the elderly and 14% of children were officially designated as poor; in 1990, 12% of the elderly and 21% of children were poor); cf. Peter Gerner & Ronald Kotulak, *Do We Want to "Cure" Aging? Extending Life Raises Fear As Well As Hope*, CHI. TRIB., Dec. 15, 1991, at C1 ("Former Colorado Gov. Richard Lamm hit a raw nerve in 1984 when he was quoted as saying that older people 'have a duty to die and get out of the way.'").

On the family level, one can doubt whether most Americans above the poverty line suffer from an increased generational split. Generally, the family forms a cohesive economic unit whose goal is to preserve family assets (human capital as well as financial capital)<sup>30</sup> while shifting as many costs as possible to outsiders. Thus, we might really be witnessing an interfamily struggle masquerading as an intergenerational one. That is, popular support for federal entitlement programs seems based on the perception that the cost will be borne by someone else, or, at worst, by someone else's kids.<sup>31</sup> Why else would you see a family complain that Medicare should pay for long-term nursing home care so that the elderly parents can leave their substantial savings to their children?<sup>32</sup>

At the societal level, issues of intergenerational equity are debated in the context of federal deficit spending. In analyzing who bears the burden of the federal deficit, economists Alan Auerbach, Jagadeesh

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30. See generally Gary S. Becker, *A Theory of Social Interactions*, 82 J. POL. ECON. 1063, 1077 (1974) ("[A]lthough children usually eventually set up their own households and fully control their own incomes, the head [of the family] would guide and help finance their investments in education and other human capital to maximize the present value of the real income yielded by these investments.").

31. Perhaps this explanation gives the general population too much credit. Cf. Kathleen Day, *Soaring Bailout Cost Puts S&L Crisis in Public Eye*, WASH. POST, June 4, 1989, at H1 ("Why can't the government pay for [the savings and loan bailout] instead of the taxpayer?" asked one man, a question cheered by the crowd of several hundred people.").

32. See, e.g., *The MacNeil/Lehrer NewsHour* (PBS television broadcast, Apr. 29, 1993) available in LEXIS, NEWS Library, MACLEH File (interview with Paul Hewitt, National Taxpayers Union) ("[S]ay somebody with \$ 1/2 million, which is not an unusual case for an elderly family . . . , if they don't spend the extra thousand dollars a year [on long-term care insurance] . . . to protect their wealth . . . then . . . they and their heirs will suffer the consequences. There is a program for poor people. It is [Medicaid]."). OBRA 1993 tightened up loopholes that allow the elderly to appear to be "spending down" their wealth while maintaining effective control or enjoyment of income. OBRA 1993, *supra* note 8, § 13611; H.R. REP. NO. 213, 103d Cong., 1st Sess. 834-35 (1993) [hereinafter OBRA Conference Report]; see Richard Schroeder, *A Threat to Senior's Security*, BUFF. NEWS, June 23, 1993, § Your Money, at 1; compare Cheryl Lavin, *The Medicaid Game: To Qualify for Nursing Home Assistance, Some People Become Paupers on Paper. It's Legal, But Is It Right?*, CHI. TRIB., Jan. 31, 1993, at C1 ("Sen. Carol Moseley-Braun (D-Ill.) . . . was criticized for taking part of her mother's windfall check of \$28,750 from the sale of timber rights while her mother's nursing home bills were being paid by Medicaid." However, "there's no law that makes children financially responsible for their parents.") with Jonathan Marshall, *A Warning on Cost of Long-Term Care*, S.F. CHRON., May 26, 1993, at A4 ("Germany . . . keeps its institutionalization rate below that of the United States in part by weighing the financial resources of both the elderly and their grown children before paying for care.") and Stephen A. Moses, *Stop the Medicaid Gravy Train*, BEST'S REV. — LIFE-HEALTH INS. ED., Oct. 1991, at 128, available in LEXIS, NEWS Library, BRLIFE File (explaining that if, as the Inspector General of Health and Human Services recommended in 1988 and 1989, Congress mandated asset recovery from the estates of Medicaid nursing home beneficiaries, both generations would have an incentive to obtain long-term care insurance, perhaps from the parents' "massive home equity — in excess of \$800 billion nationally"). Congress adopted such a rule in OBRA 1993, *supra* note 8, § 13612.

Gokhale, and Laurence Kotlikoff recently posited "generational accounts" to illuminate how much "different generations [are] paying to finance government consumption and to subsidize each other."<sup>33</sup> Their theory is driven by the recognition that somebody has to pay, if not now then later — this is, in economics terms, "the government's intertemporal budget constraint."<sup>34</sup> Their generational account analysis of the federal deficit calculates both expected government receipts (tax collections) and expected transfer payments (such as Social Security and Medicare).<sup>35</sup> The study concludes, among other things, that significant "birth bills" could be presented to those born in 1989 and in later years: "[U]nless policy toward existing generations . . . is substantially altered . . . , future generations will face a roughly 20% larger net tax burden over the course of their lifetimes than current newborns."<sup>36</sup> A more thorough treatment of generational accounts by Professor Kotlikoff reveals the 1950s through the 1970s to be the greatest era of increasing burdens on future generations, while the 1980s (largely due to the Social Security funding reforms) actually benefited future generations.<sup>37</sup>

This generational account approach makes certain controversial and difficult assumptions and rejects others. First, it assumes that deficit spending is making our children worse off: the resolution of this question depends on how the government is spending the money, and the implications for growth.<sup>38</sup> Additionally, the theory rejects

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33. Alan J. Auerbach et al., *Generational Accounts: A Meaningful Alternative to Deficit Accounting*, in 5 TAX POL'Y & ECON. 55, 57 (David Bradford ed., 1991). President Clinton's FY 1995 Budget includes a novel section on generational accounting. See *Clinton Budget Cites Age-Based Disparities in Tax Treatment, Based on 'Generational Accounting'*, Feb. 15, 1994, available in LEXIS, FEDTAX Library, TNT File, as 94 TNT 31-63 (containing excerpt from the Budget Report).

34. Auerbach et al., *supra* note 33, at 59. That is, the government must live within its means, taking into account its ability to finance a current "expansionary" (debt-financed) budget through future taxes.

35. *Id.* at 65, 69-71.

36. *Id.* at 92. The authors further estimated that federal government zero growth ("getting spending under control") would reduce the burden on future generations by more than one-fourth of what it otherwise would be. *Id.* at 91. "The effect of [a zero-growth] policy is to lower the present value of government consumption by \$1.306 trillion, which is sizable compared to what would otherwise be the burden on future generations, namely \$4.903 trillion." *Id.*

37. LAURENCE J. KOTLIKOFF, *GENERATIONAL ACCOUNTING: KNOWING WHO PAYS, AND WHEN, FOR WHAT WE SPEND* 166-85 (1992).

38. See, e.g., Robert Eisner, *Deficits: Which, How Much, and So What?*, 82 AM. ECON. REV. PAPERS AND PROC. 295, 297 (1992) (the deficit is not measured right if government expenditures are "financing real government investment in public capital or private households' investment in durable goods or human capital"); David M. Cutler, Book Review, NAT'L TAX J., Mar. 1993, at 61, 66 (reviewing KOTLIKOFF, *supra* note

Robert Barro's assumption that the altruistic motives of the senior generation will cause them to maintain current consumption at the level it would have been absent the effective transfer program, allowing them to pass through the government transfers to the next generation as increased bequests.<sup>39</sup> Finally, impairing the notion that generational accounting can accurately calculate "birth bills" for each newborn age group, nothing keeps future generations from "defaulting" when the bills fall due, by rolling over Treasury borrowing and promising to raise taxes *another X years* down the road.<sup>40</sup>

In our current frigid climate of deficit reduction, federal aid to college students has increasingly shifted from a program of grants to a program of loans.<sup>41</sup> As a result, two education scholars have accused current parents of breaking the educational "intergenerational compact."<sup>42</sup> No model of who should pay for college is more right

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37), reprinted in 60 TAX NOTES 361, 364 (Robert J. Wells ed., 1993) ("Kotlikoff's generational accounts ignore the distribution of nonentitlement spending, since it is unclear *ex ante* how much each generation values them. One could argue, however, that the returns to military spending in the past several decades have been very large."). Moreover, deficit spending did not occur by accident; policymakers counted on the Ponzi scheme of succeeding standards of living. See, e.g., Phillip Longman, *Justice Between Generations*, ATLANTIC MONTHLY, June 1985, at 73, 76 (quoting economist Gordon Tullock that to deprive one's generation at the expense of the next would "clearly tax the poor to help the rich"). See generally Cutler, *supra*, at 64 ("A fair reading of the evidence is that the available evidence does not offer firm conclusions about the economic effects of the deficit.").

39. See Robert J. Barro, *Are Government Bonds Net Wealth?*, 82 J. POL. ECON. 1095 (1974). *Contra* B. Douglas Bernheim & Kyle Bagwell, *Is Everything Neutral?* 96 J. POL. ECON. 308 (1988) (because any one person is part of so many different family groups, Barro's altruistic model produces absurd neutrality results). Even if the senior generation wanted to neutralize government programs, it would need a tremendous amount of information to ferret out all the effective government transfers. See HARVEY S. ROSEN, PUBLIC FINANCE 425 (2d ed. 1988) ("Information on the implications of current deficits for future tax burdens is not easy to obtain. . . . Is it sensible to think that people seek out this information, correctly analyze it, and then use the information to make optimal bequests?"); cf. *Social Security: Data Show Class of Retirees Already Will Receive Less in Benefits than Taxes Paid*, DAILY TAX REP., Mar. 12, 1993, at G-5, G-6 ("[John] Shoven also suggested that [the] Social Security [Administration] institute a mailing of annual statements to all participants to inform them of their status in the system and to educate them on the need for supplementary saving to finance an adequate standard of living in retirement.").

40. Cutler, *supra* note 38, at 65 (arguing that one cannot meaningfully assign an expected value to taxes and spending, because "how is one to know which promises the government would keep?").

41. NATIONAL CTR. FOR EDUC. STATISTICS, *supra* note 20, at 331, Tbl. 47-2 (the guaranteed student loan program grew 82.7% in constant dollars from 1980 to 1991, and cost the federal government \$4.2 billion in 1991); see also THOMAS G. MORTENSON, ACT STUDENT FIN. AID RES. REP. SERIES, PUB. NO. 90-1, THE IMPACT OF INCREASED LOAN UTILIZATION AMONG LOW FAMILY INCOME STUDENTS 4, Fig. 1 (1990) (showing that from 1975 to 1988, the percentage of federal financial aid representing gifts declined steadily from over 75% to just over 30%, while the percentage representing loans increased steadily from 20% to 65% — the lines look like a giant "X" on the grid). The federal student loan program is discussed *infra* part II.B.

42. MICHAEL S. MCPHERSON & MORTON O. SCHAPIRO, KEEPING COLLEGE AFFORDABLE: GOVERNMENT AND EDUCATIONAL OPPORTUNITY 175 (1991).

than another, they say; it's just that the current generation of adults gets the transitional free ride. Another scholar states the issue more bluntly: "Finally, as a part of a far broader moral question of public finance, by what right does a generation of adults educated without loans obligate their children to pay for their own education?"<sup>43</sup> An argument like this resonates in an era coming to grips with a new concept of family, where ties form, are broken, and are reformed with new "parents."<sup>44</sup> However, a contrary view suggests that the tradition of parents' funding their children's education "is breaking down in any case, due both to the prolongation of graduate and professional education well into young adulthood and to the increasing desire of the young for emancipation from parental authority and responsibility."<sup>45</sup>

In examining the underlying claim that a shift from grants to loans represents a shift from the older to the younger generation, let's not get tricked by the *nominal incidence*, as opposed to the *economic incidence*, of the burden. When the government bestows college grants, who pays? You want to say "current taxpayers" — who are much more likely to be the parents of the students than the students themselves. As we just saw, however, the government cannot definitively impose costs on any particular generation, and grants might be borne by each generation of college students, through higher taxes during their working lives.

Additionally, state and local colleges and universities charge the

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43. MORTENSON, *supra* note 41, at 50. As just discussed, analysis of deficit spending is more complicated — for example, the resulting expansion of the economy in the 1980s made possible higher compensation levels for college graduates, so the investment might already be paying off for them.

44. See, e.g., Ahlburg & De Vita, *supra* note 27, at 30 ("Through divorce and remarriage, individuals are related to more and more people, to each of whom they owe less and less.") (quoting FRANK F. FURSTENBERG, JR. & ANDREW J. CHERLIN, *DIVIDED FAMILIES: WHAT HAPPENS TO CHILDREN WHEN PARENTS PART* 95 (1991)); cf. *Bowen v. Gilliard*, 483 U.S. 587, 633 (1987) (Brennan, J., dissenting) (a welfare program that punishes families when fathers stay involved in the financial lives of their children recalls Aristotle's criticism of the Platonic Republic: "[E]ach citizen will have a thousand sons: they will not be the sons of each citizen individually: any and every son will be equally the son of any and every father; and the result will be that every son will be equally neglected by every father.") (alteration in original) (quoting *THE POLITICS OF ARISTOTLE* 44 (Ernest Barker trans., 1958)).

45. D. BRUCE JOHNSTONE, *NEW PATTERNS FOR COLLEGE LENDING: INCOME CONTINGENT LOANS* 14 (1972); see also Morse, *supra* note 17, at 4 (in 1958 Congress enacted a student loan program rather than a direct grant program in part because the House leaders "who had gone to college had done so during the Depression years. They had, literally, worked their way through college and saw no reason why succeeding generations could not do likewise.").

student a fraction of the cost of an education at a private institution, where costs are much less far apart.<sup>46</sup> Who “pays” for this subsidy?<sup>47</sup> Forty-eight states require a balanced enacted budget. Thus, it appears that current taxpayers bear state expenses. However, state requirements focus primarily on balancing the “general fund,” which ranged from twenty-one percent to seventy-four percent of total state spending in fiscal year 1990.<sup>48</sup> General funds exclude state funds such as those for capital improvements, which are financed primarily from borrowing; so, along with neglected infrastructure spending,<sup>49</sup> we are back where we started from.

Even within a family, you cannot determine who bears the burden of a particular financial obligation without knowledge of all other transfers — past, current, and future — that will be made among its members.<sup>50</sup> In the simplest case, the student’s parents can make gifts

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46. NATIONAL CTR. FOR EDUC. STATISTICS, *supra* note 20, at 136. Tuition charges cover 19.5% of costs at public institutions and 55.9% at private institutions. *Id.* at 134. See also Helen F. Ladd, *Comment*, in STUDIES OF SUPPLY AND DEMAND IN HIGHER EDUCATION, *supra* note 19, at 278 (response to John M. Quigley & Daniel L. Rubinfeld, *Public Choices in Higher Education*, in STUDIES OF SUPPLY AND DEMAND IN HIGHER EDUCATION, *supra* note 19, at 243) (“In 1989, spending on higher education accounted for 20 percent of total direct spending by states and exceeded 25 percent in 11 states.”). States do not deprive higher-income students of the subsidized tuition. See, e.g., Samuel Weiss, *Study Says Middle Class Are Drawn to SUNY*, N.Y. TIMES, Nov. 4, 1992, at B18 (report by a group representing private institutions showed that 60% of full-time undergraduates at the State University of New York’s four-year schools come from families whose annual income exceeds \$50,000, compared with only 45% in the state’s private schools, where average tuition is four times as high).

47. Perhaps “why” is a better question. Compare John M. Quigley & Daniel L. Rubinfeld, *Public Choices in Public Higher Education*, in STUDIES OF SUPPLY AND DEMAND IN HIGHER EDUCATION, *supra* note 19, at 256 (“legislatures in states with substantial private alternatives tend to charge higher tuition than do states with relatively little to offer in the private sector”) with Ladd, *supra* note 46, at 282-83 (are legislatures trying to keep costs low at public colleges in order “to transfer resources to middle-income taxpayers” or because they think low tuition will encourage growth in “the supply of human capital in the state?”). Over twenty years ago, the governor of Ohio proposed that students graduating from institutions in the state (public or private) be required to repay the state subsidy (without interest), at the rate of 2% of income (but not for longer than thirty years). See JOHNSTONE, *supra* note 45, at 81 (characterizing the Ohio Plan, which was never enacted by any state legislature, as a “state educational income surtax”). A recent hot issue in the public higher education field is “high tuition, high aid,” to better target state subsidies to the needy. See, e.g., NATIONAL COMM’N ON RESPONSIBILITIES FOR FIN. POST-SECONDARY EDUC., *supra* note 15, at 57-58 (expressing concern that the recent trend appears to be high tuition, low aid).

48. See, e.g., GENERAL ACCOUNTING OFFICE, PUB. NO. GAO/AFMD-93-58BR, BALANCED BUDGET REQUIREMENTS: STATE EXPERIENCES AND IMPLICATIONS FOR THE FEDERAL GOVERNMENT (1993).

49. *Id.*

50. Laurence J. Kotlikoff, *Taxation and Savings: A Neoclassical Perspective*, 22 J. ECON. LIT. 1576 (1984) (contrasting life cycle (“selfish”) models, in which individuals save in order to smooth their own lifetime consumption and so bequests play a small role, with dynastic (“altruistic”) models, in which saving for private intergenerational transfers explains much of the current stock of U.S. wealth); Laurence J. Kotlikoff & Lawrence H. Summers, *The Role of Intergenerational Transfers in Aggregate Capital*



to their child to enable her to repay the loan.<sup>51</sup> The large investments parents in America make in the education of their children leads to the common observation that the greatest legacies we receive from our parents and will leave to our children is human capital rather than financial capital.<sup>52</sup>

Transfers go the other way, too. The sandwich generation feels the pinch of supporting their elderly parents just when their own children reach college age.<sup>53</sup> Recent economic literature argues that parents accumulate sufficient capital to make bequests not out of altruism or a sense of dynasty but as a weapon to hold over a child in order to induce the child to provide necessary care to them in their old age.<sup>54</sup> According to this complex model of financial and

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*Accumulation*, 89 J. POL. ECON. 706 (1981); Franco Modigliani, *The Role of Intergenerational Transfers and Life Cycle Saving in the Accumulation of Wealth*, 2 J. ECON. PERSP. 15 (1988).

51. Cf. David Altig & Stephen J. Davis, *The Timing of Intergenerational Transfers, Tax Policy, and Aggregate Savings*, 82 AM. ECON. REV. 1199, 1206 (1992) ("Parents choose the timing of intergenerational transfers to exploit the wedge between the after-tax borrowing rate faced by the child and the after-tax rate of return on own savings." Where borrowing rates exceed lending rates, "the marginal rate of substitution of current for future consumption is higher . . . for children than for parents. Thus, transfers early . . . in the life cycle dominate transfers late . . . in the life cycle."). In one study (whose sample was admittedly too small to allow for generalizations), however, only 10.8% of respondents stated that their parents have helped or intended to help them pay off student loans. Dennis J. Martin, *Repayment, Responsibility, and Risk*, in STUDENT LOANS: RISKS AND REALITIES, *supra* note 11, at 25, 30-32 ("The most likely groups of borrowers to report such help are those whose parents had incomes of \$50,000 or more (while the borrower was enrolled), younger borrowers recently out of school, and those whose parents assisted in meeting college costs while the borrower was in school"; but only 19% of respondents in these subsets reported parental repayment assistance). The same study showed that 9% of respondents borrowed from their parents. *Id.* at 34, Tbl. 2-1.

52. See, e.g., Theodore W. Schultz, *Investment in Human Capital*, 51 AM. ECON. REV. 1, 11 (1961) (estimating that "the stock of education in the labor force rose about eight and a half times between 1900 and 1956, whereas the stock of reproducible capital rose four and a half times, both in 1956 prices"); cf. Barro, *supra* note 39, at 1104 ("the crucial consideration" for the neutrality result "is an operative intergenerational transfer, rather than an operative bequest motive per se. For example, the transfer could take the form of parental expenditure on the children's education, etc.").

53. See, e.g., Barbara Vobejda, *Caring for 3 Generations; Families Juggle Needs of Elderly, Young*, WASH. POST, Nov. 24, 1990, at A1 ("The growth of the so-called 'sandwich generation' is the coincidental result of two demographic trends: prolonged life span . . . and the tendency among couples to delay marriage and childbirth into their thirties"); Lee Smith, *What Do We Owe the Elderly?*, FORTUNE, Mar. 27, 1989, at 54.

54. See, e.g., Donald Cox & Mark R. Rank, *Inter-Vivos Transfers and Intergenerational Exchange*, REV. ECON. & STAT. 305, 307 n.4 (1992) ("[P]arental compensation for services need not be contemporaneous. Parents may defer payments as bequests to insure that they have the 'last word' in bargaining with children. Alternatively, parents might pay for services in advance if their children face liquidity constraints early in

labor interdependence, parents could not long gain from "shifting" the economic burden for a college education onto their children. The kids might just conclude that their parents are reducing the value of their bequests, and so would reduce the level of their filial services.<sup>55</sup>

But cost is only one side of the calculation. Because, as already discussed, the students (and their families) can capture the financial benefit of a college education, it seems odd that we base scholarships and interest rate subsidies to students so greatly on their parents' resources.<sup>56</sup> In sum, an education that will pay off is precisely the type of expenditure for which a loan is suitable. Government loans are a better idea than grants not necessarily because *children* should pay their own way but because families, if they are capable, should pay their own way. We can expect a student to choose her courses more wisely if she knows that she and she alone must finance the expense. Put more theoretically, why should any one student (or her family) have the right to require all taxpayers to support her human

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life."); Longman, *supra* note 38, at 81 (describing fathers in Colonial New England retaining power over their middle-aged children by waiting as long as possible to convey title to farmland; the remedy for children's increased independence in our post-agrarian economy "has been to allow each generation to tax its children, through such programs as Social Security and Medicare"); Robert A. Pollak, *A Transaction Cost Approach to Families and Households*, 23 J. ECON. LIT. 581, 604 (1985). Specifically:

The altruistically motivated transfers one observes in the United States may come in the form of less than fully efficient educational support to liquidity-constrained children . . . , in-kind transfers by paternalistic altruists . . . , incentive-oriented transfers by altruistic parents concerned about free-riding children . . . , and end-of-life transfers by parents concerned that children will squander what they receive at an early age and ask for more. . . .

While liquidity-constrained, paternalistic, and strategically constrained altruism may abound, our findings nevertheless indicate that changing the distribution of resources within the extended family significantly changes its distribution of consumption.

Joseph G. Altonji et al., *Is the Extended Family Altruistically Linked? Direct Tests Using Micro Data*, 82 AM. ECON. REV. 1177, 1196 (1992). If parents and children within a family tend to spend the money they have, this result bodes ill for hopes that current large governmental transfer payments to the elderly are being saved for bequests. See Cutler, *supra* note 38, at 64 (empirical studies of consumption under the life cycle or permanent income theory demonstrate that people "are 'overly sensitive' to current income," thus suggesting that a cash-flow accounting mechanism rather than a generational accounting mechanism more accurately describes the effects of the government debt). I discuss the life cycle model of saving and consumption, along with Milton Friedman's permanent income hypothesis, in part I.C.3, in the context of a consumption tax; and in part I.D, in the context of the lifetime pattern of earnings.

55. Barro calls for further analysis of the situation, posited by Gary Becker, where "the child has some information on the size of his parents' estate and that — acting as a good optimal controller — he regulates the amount of attention as a function of the estate size." Barro, *supra* note 39, at 1106 n.14.

56. See, e.g., Michael S. McPherson & Mary S. Skinner, *Paying for College: A Lifetime Proposition*, BROOKINGS REV., Fall 1986, at 29, 34 (if we believe that students should pay for their own education, then "[l]ong-term loans with income insurance could permit students to handle the load, and family background could, at least in principle, be largely ignored in determining how students would pay for college"). Current financial-needs tests are discussed *infra* part II.B.

capital investment decision? Otherwise, poorer taxpayers who did not go to college subsidize those who did. We should devote our scarce collective resources to those who cannot over a significant period of their adult lives get by without financial aid.<sup>57</sup>

### C. When Does a New Taxpayer Come into Being?

In the previous section we finessed the unanswerable question of who, as between parents and child, "bears" the burden of college expenditures (and reaps the financial rewards). Theoretical perfection, however, is a luxury our public finance system cannot demand. Our tax rules apply rough justice in determining "who is the taxpayer" for purposes of reporting income or claiming deductions. Expenditures on education for a *young* child appear to "belong" to the parents, because we view young children almost as items of consumption by parents. We treat college expenses more ambiguously, if not ambivalently. In part I.E we review the tax treatment of higher education expenditures. Whose expenditures are these?

Consider the following examples of household or family arrangements that our tax system addresses very simplistically:

- A married couple moves from a one-bedroom apartment to a three-bedroom house when they start a family.<sup>58</sup> Is any part of the expenses of the

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57. Theodore Schultz notes: "Physical capital that is formed by public investment is not transferred as a rule to particular individuals as a gift." Schultz, *supra* note 52, at 15. Why, then, might it be appropriate for the government to spend money on human capital whose benefits can be captured by the educated? Schultz suggests that such a policy might further a "strong welfare goal of our community . . . to reduce the unequal distribution of personal income among individuals and families." *Id.* However, Schultz also calls for long-term private and public loans to students as a remedy for capital market imperfections. *Id.* (note that this 1961 article pre-dates the Higher Education Act of 1965 that created the guaranteed student loan program, discussed *infra* part II.B).

58. Compare:

[T]he British obsession with buying a home rather than renting one is pernicious. It restricts labour mobility: unemployed workers who own rather than rent cannot easily move to find jobs. It diverts money from more productive investment. And the housing market has been an engine for inflation. A country less obsessed with home ownership might be less prone to booms and busts; witness Germany.

*After the Crash: Britain's Home Buyers and Lenders Need Less Help, Not More*, ECONOMIST, Nov. 21, 1992, at 14, 17 [hereinafter *After the Crash*]. The U.S. treasury loses a combined \$86 billion a year from the deductibility of home mortgage interest and property tax, the deferral of gains on sales of principal residences, and the exclusion of gains on principal residence sales by those aged fifty-five and over. STAFF OF THE JOINT COMM. ON TAX'N, 103D CONG., 1ST SESS., ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 1994-1998, Tbl. 1 (Comm. Print 1993) (under the category "Commerce and Housing") [hereinafter JOINT COMM., ESTIMATES OF FEDERAL TAX EXPENDITURES] (as described in part I.E.2, however, an interest deduction is not the "tax expenditure," but

larger abode allocable to the children? What if an adult child moves back in with her parents — does it (should it) matter whether the parents charge her rent?<sup>59</sup>

- Kate and Allie, two single mothers, move into a house together, with their children, to keep down expenses and to share childrearing duties. At what rate do they pay tax on their two salaries and other income?<sup>60</sup>
- A 17-year-old, who hopes to be a dancer, breaks her ankle. Her medical costs may be taken into account on her parents' tax return,<sup>61</sup> even though, like an investment in a college education, the expenditure will increase her future earnings capacity.<sup>62</sup>
- A middle-aged widow pays her mother-in-law's nursing home expenditures. State law imposes no obligation to support adults; if the annual bills

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rather the tax expenditure is the failure of our system to tax imputed rental income; see BRADFORD, *supra* note 3, at 2). We lose at a personal level, too, from the stress that saving up for our own home — the great American dream — brings to our young adult years. *After the Crash*, *supra*, at 17 (“Buying a house is reckoned to be the most stressful experience in an individual's life, after marriage and divorce, and is a not-infrequent cause of the latter.”).

59. Recent news stories attest to the growing trend in baby birds who either refuse to leave the nest, or who return after college. See, e.g., Richard Whitmire, *Older Children Staying at Home with Parents*, Feb. 11, 1993, available in LEXIS, NEWS Library, GNS File (according to the Census Bureau, 58% of unmarried Americans between twenty and twenty-four lived with their parents in 1992); Katherine Boo, *Grow Up Twenty-Somethings. You Can Go Home Again*, WASH. MONTHLY, Apr. 1992, at 31 (“Today, thanks largely to high rents and low wages, more than 18 million single adults aged 18-34 live with their parents — a phenomenon that has the psychologists apoplectic. ‘Failed adults,’ they term these young people: a generation of budding Norman Bateses spoiled by affluent parents.”); see also, Jane Bryant Quinn, *Feeling the Boomerang Effect, Many Young Single Adults Are Going Home to Live With Mom and Dad*, CHI. TRIB., Apr. 12, 1993, at C11 (only 25% of kids pay any rent to their parents).

60. A tax schedule halfway between that for a single taxpayer and that for married taxpayers at the same combined income applies for a “head of household” (generally, a single taxpayer with at least one child). I.R.C. § 1(a)-(c) (rates); I.R.C. § 63(c) (standard deductions). Congress's General Accounting Office (GAO) urged repealing the existing complicated support calculations required to claim both the dependency deductions and favorable head of household status, and replacing these rules with one that looked simply to the residence of the child. GENERAL ACCOUNTING OFFICE, PUB. NO. GAO/GGD-93-60, TAX ADMINISTRATION: ERRONEOUS DEPENDENT AND FILING STATUS CLAIMS (1993), available in LEXIS, FEDTAX Library, TNT File as 93 TNT 72-34 [hereinafter GENERAL ACCOUNTING OFFICE]. A residency-based test reflects the “reality” that “taxpayers already appear to be claiming exemptions when the dependent lives with them.” *Id.*; see also Tax Simplification for Families Act of 1993, S. 939, 103d Cong., 1st Sess. (1993), proposed by Senators Moynihan and Packwood, discussed *infra* note 84. The GAO recognized, however: “If the maintenance test were eliminated, single parents who share housing or receive housing assistance from government or other sources could each file as a head of household. We do not know how this change would affect the number of head of household claims.” GENERAL ACCOUNTING OFFICE, *supra*.

61. A taxpayer may claim, to the extent they exceed 7.5% of adjusted gross income, medical expenses paid for the taxpayer, the taxpayer's spouse, and a dependent of the taxpayer (special rules apply for divorced parents). I.R.C. § 213.

62. See, e.g., Schultz, *supra* note 52, at 9; Paul B. Stephan III, *Federal Income Taxation and Human Capital*, 70 VA. L. REV. 1357, 1380-81 (1984). Indeed, in the poorest economies, food can be an item of investment. Schultz, *supra*, at 5 (“On the ‘hungry’ steppes and in the teeming valleys of Asia, millions of adult males have so meager a diet that they cannot do more than a few hours of hard work.” In these cases, “it is certainly meaningful to treat food partly as consumption and partly as a current ‘producer good,’ as some Indian economists have done”).

exceed \$10,000 (as is likely),<sup>63</sup> is the payment subject to gift tax?<sup>64</sup>

### 1. Income Tax Considerations

Our federal tax system has to deal with the metaphysical all the time. The miracle of two souls combining into one reduces to the simple rule: Were the two of you married on December 31?<sup>65</sup> Moreover, we know for sure that life begins for federal tax purposes upon the birth of a child.<sup>66</sup>

63. The annual cost of a nursing home stay in 1988 averaged about \$25,000; some exceeded \$75,000 or even \$100,000. See Dana Shilling, *Securities Funding of Long-Term Care: A Step Toward a Private Sector Solution*, 19 FORDHAM URB. L.J. 1, 2 (1991) ("Home care can be equally expensive, or even more costly . . . because it may be necessary to hire three shifts of unskilled workers as well as retaining the occasional services of several health care professionals.").

64. Section 2503(e), added to the Internal Revenue Code by the Economic Recovery Tax Act of 1981, Pub. L. 97-34, 95 Stat. 319 (1981), excludes from the gift tax amounts paid for medical care for any person, regardless of their relationship. I.R.C. § 2503(e). The definition of "medical expenses" contained in Treas. Reg. § 25.2503-6(b)(3) (1984) does not appear to reach the bulk of nursing home expenses.

65. OK, maybe not quite so simple. See I.R.C. § 7703 (equally brightline but arbitrary rules in the case of death of a spouse and divorce or separation).

66. This question provided the script for a bizarre and ghoulish skirmish prompted by anti-abortion members of Congress. In 1972, the Internal Revenue Service found itself considering a revenue ruling concluding that a taxpayer may claim a dependency exemption "for his child who lived only momentarily after being prematurely born alive in a hospital in an operation to terminate a pregnancy by induced abortion." See Gen. Couns. Mem. 35,124 (Nov. 17, 1972). Evidently, no real taxpayer ever sought this opportunistic tax result. Rather, abortion foes raised the question because "[t]he possibility that someone might [claim the dependency exemption] should not even exist." Lee A. Sheppard, *Senator Humphrey Continues Anti-Abortion Effort*, 32 TAX NOTES 298, 301 (1986) (paraphrasing the position of Sen. Jesse Helms). The IRS Chief Counsel urged the ruling drafters, in view of the "morally and emotionally sensitive issue of abortion," to adopt "a more general revenue ruling broad enough to cover all live births regardless of their natural or artificial inducement." Gen. Counsel Mem. 35,124, *supra*. See Rev. Rul. 73-156, 1973-1 C.B. 58 (result so modified).

The abortion foes had one more angle. In order to be entitled to a dependency exemption the taxpayer must provide over half the support of the dependent. I.R.C. § 152. Because the only expenditures made for the aborted baby *after it was born* but before it died were the medical expenses of the abortion itself, the next "logical" question was whether these expenses counted as support of the baby. At the behest of Sen. Helms and others, the Chief Counsel revoked its 1972 memorandum. See Gen. Couns. Mem. 39,394 (Aug. 5, 1985). The Service thereupon issued a new revenue ruling concluding: "Expenses for an induced abortion . . . are not incurred for the benefit of the child and do not qualify as an item of support . . . for a child born alive during the tax year." Rev. Rul. 85-118, 1985-2 C.B. 59, 60, *clarifying* Rev. Rul. 73-156. Which prompted one tax attorney to write to *Tax Notes* magazine:

What would we do without the IRS around to tell us in Rev. Rul. 85-118 that expenses incurred to induce an abortion do not qualify as an item of support under section 152 when the baby lives? There are easily thousands of difficult tax law issues that we need guidance on, but instead we get garbage like this from that esteemed agency. No wonder nothing is getting done.

The revenueur knows more than ontology. Nearly every issue in the study of the federal income tax comes down to one (or a combination) of the "four questions," which the Internal Revenue Code, in its ever-expanding prolixity, purports to answer to a certainty: What is income? When is it income? To whom is it income? And, a different kind of question, at what rate should that income be taxed?

The "to whom" question asks us to figure out which person in an economic arrangement should be the taxpayer. Lawmakers and academics tend to focus on whether the family should be viewed as a single taxpaying unit.<sup>67</sup> Currently, the spouse with the secondary income (usually the wife) generally pays tax at the primary earner's marginal rate.<sup>68</sup> Aside from married couples,<sup>69</sup> each family member

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Joe Henderson, *Letter to the Editor*, 28 TAX NOTES 919 (1985).

Several conservative legislators then attempted to stall the 1986 Tax Reform Act (as well as the nomination of Lawrence B. Gibbs to be IRS Commissioner) with various anti-abortion proposals. See, e.g., Sheppard, *supra*, at 298. For example, Sen. Helms introduced legislation to "clarify the IRS's definition of support and deny a deduction to a parent who intended to abort a child, but had the 'misfortune' of having the baby survive a few minutes." *Helms Bill Would Clarify Cloudy IRS Ruling Regarding Dependent Deduction*, 30 TAX NOTES 1011 (1986). History records both the successful enactment of the Tax Reform Act of 1986 unsullied by special rules for abortion and a successful tenure by Commissioner Gibbs.

67. Even our system of joint filing for spouses raises issues of tax fairness. As of October 1991, 15 of the 24 countries of the Organization for Economic Cooperation and Development use the individual as the taxation unit for the earned income tax credit; five countries have joint or family taxation; and four countries allow married couples to choose between joint or individual declarations. *International Taxes: OECD Report Says More than Half of Member Countries Use Individual as Unit for EIC*, DAILY TAX REP., Dec. 3, 1991, at G-9, G-10 (citing ORGANIZATION FOR ECON. COOPERATION AND DEV., PUB. NO. ISBN 92-64-03519-2, THE TAX/BENEFIT POSITION OF PRODUCTION WORKERS, 1987-1990 (1991)). As recently as 1970, only six countries recognized the individual as the taxpayer. *Id.* Nine countries permit spouses to transfer some unused tax allowances between them. *Id.* Four countries give no tax relief for marriage. *Id.* Six countries treat "informal unions" between persons of different sexes as marriage for tax purposes. *Id.*

68. Professor McCaffery objects to this formula as "marginalizing" working wives. Edward J. McCaffery, *Taxation and the Family: A Fresh Look at Behavioral Gender Biases in the Code*, 40 UCLA L. REV. 983, 993-94 (1992). See also JOSEPH PECHMAN, FEDERAL TAX POLICY 107 (5th ed. 1987) ("When the number of tax brackets and tax rates was reduced in 1986, Congress decided to eliminate the two-earner deduction. Although the lower tax rates moderate the disadvantage of two-earner couples, they did not eliminate it entirely. Thus, on equity grounds, the two-earner deduction should be restored."). The higher marginal rates contained in OBRA 1993, *supra* note 8, will only exacerbate the marriage penalty. See I.R.C. § 1(a).

69. See, e.g., Boris I. Bittker, *Federal Income Taxation and the Family*, 27 STAN. L. REV. 1389 (1975); Pamela B. Gann, *Abandoning Marital Status as a Factor in Allocating Income Tax Burdens*, 59 TEX. L. REV. 1 (1980); Michael J. McIntyre & Oliver Oldman, *Taxation of the Family in a Comprehensive and Simplified Income Tax*, 90 HARV. L. REV. 1573 (1977); Laura A. Davis, Note, *A Feminist Justification for the Adoption of an Individual Filing System*, 62 S. CAL. L. REV. 197 (1988). McCaffery points out the Social Security and Medicare payroll taxes are applied separately to the wages of each spouse, even though the benefits are, in many cases, based on the income of the spouse. McCaffery, *supra* note 68, at 996-1001.

constitutes a distinct taxpaying unit.<sup>70</sup> Accordingly, Congress's recent attention has focused largely on devices for income-shifting from high-income parents or grandparents to low-income children. In some cases, Congress requires minors to pay tax at their parents' marginal rate.<sup>71</sup> Our complicated system of taxing trusts attempts to assign income to the proper person. In addition, difficult issues arise when families engage in income splitting by, for example, having the parents hire the children<sup>72</sup> or bringing them into the family business conducted in partnership or S corporation form.<sup>73</sup>

However, the financial resources of a household are affected profoundly by the number and ages of the members of that household (whether or not the members have any blood or legal relationship), and their net financial contribution to or burden on that household.<sup>74</sup>

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70. Note particularly I.R.C. § 73, which requires a minor child to include payments for her services in her income, even if the child does not receive payment. *See, e.g., Allen v. Comm'r*, 50 T.C. 466 (1968), *aff'd*, 410 F.2d 398 (3d Cir. 1969) (\$70,000 signing bonus paid by the Philadelphia Phillies baseball team to Richard Allen's mother taxed to the child); *see also* I.R.C. § 6012(b)(2) (requiring guardian to file return on behalf of individual unable to do so); I.R.C. § 6201(c) (if the child fails to pay tax on service income, as opposed to investment income, the tax is also considered assessed against the parent); *Bassett v. Commissioner*, 100 T.C. 650 (1993) (child actress liable for her parents' failure to file returns and pay tax, plus penalties); *Treas. Reg. § 1.6012-1(a)(4)* (1986) (return of minor). In justifying this scheme, the *Bassett* court observed: "It has been traditionally held that the parent is entitled to the wages of the child until the child reaches majority." *Bassett*, 100 T.C. at 658.

71. The Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2095 (1986), added the "kiddie tax," which generally requires the unearned income of minors to be taxed at their parents' marginal rate. I.R.C. § 1(g).

72. *Compare, e.g., Rev. Rul. 73-393*, 1973-2 C.B. 33 (to avoid penalizing "the father for employing his own child," reasonable wages paid for a minor child's services are deductible as a business expense even though the child uses the wages for his support, but, because of the father's support obligation, the value of meals and lodging furnished is neither deductible by the father nor income to the child) *with Fritschle v. Commissioner*, 79 T.C. 152 (1982) (where mother doing piece work at home causes her children to perform 70% of the work, the mother, and not the children, must report the income, because no one, including the mother, contracted or paid for the services of the children).

73. Very generally, these rules prevent the assignment of income by requiring that those partners or S corporation shareholders who perform services (generally the parents rather than the minor children) must first be adequately compensated out of partnership or S corporation income. *See* I.R.C. § 704(e) (family partnership rules); I.R.C. § 1366(e) (S corporation version of the family partnership rules); *see also* I.R.C. §§ 2701-2704 (estate freeze).

74. *See, e.g., Daniel R. Feenberg & James M. Poterba, Income Inequality and the Incomes of Very High-Income Taxpayers: Evidence from Tax Returns*, in 7 TAX POL. & ECON. 145, 150 (James Poterba ed., 1993) (Defining the income distribution over individuals raises the problem of how to treat spouses and children. "Do they receive a proportional share of household income? If so, then if a single high-income taxpayer marries a lower-income earner, she may drop out of the high-income category. The birth of children to high-income households could have the same effect."). *See infra* part I.D. for

With limited exceptions, Congress ignores these factors.<sup>75</sup>

Most basically, when does a child metamorphose from an item of her parents' consumption into a taxpayer in her own right? Surprisingly, this question receives scant attention in the law.<sup>76</sup> Aside from the "kiddie tax" (pulling the young child with unearned income back into the tax identity of the parent),<sup>77</sup> we now have only the rules that determine who may claim the "personal exemption" for a particular individual.<sup>78</sup>

Under our income tax, we generally treat a new taxpayer as coming into existence when she earns significant income in a year. In general, an individual need not file an income tax return for a particular year unless gross income exceeds both the exemption amount and the appropriate standard deduction.<sup>79</sup> Once a dependent's income exceeds the personal exemption amount, she no longer may be claimed as a dependent on anyone else's return. However, she still need not file until her income exceeds both the exemption amount and the appropriate standard deduction.

For example, assume a dependent's income consists exclusively of \$1,000 of babysitting earnings (about \$20 a week). Whether he is

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issues relating to income distribution.

75. Two of these exceptions, the dependency exemption and the filing status for heads of households, illustrate that we often impose the heaviest burden on those least able to bear it. See GENERAL ACCOUNTING OFFICE, *supra* note 60 (finding that four million taxpayers made 6.1 million erroneous claims for the dependency exemption in 1988, in many cases simply by failing to keep adequate records; adding in an estimated 1.6 million erroneous claims for head of household filing status, the fisc suffered an estimated \$1.8 billion in lost revenues in 1988). Commonly, household-based income and asset tests are applied for means-tested welfare programs, such as food stamps and Aid to Families with Dependent Children. See, e.g., *Bowen v. Gilliard*, 483 U.S. 587 (1987).

76. See Bittker, *supra* note 69, at 1448-53 (discussing the difficulties of taxing the dependent on amounts her parents spend on her support, noting also that this "conduit" model of income would tax the amounts at the child's presumably lower rate). See *infra* part I.D. for discussion of progressive rates.

77. But cf. *Gann*, *supra* note 69, at 56 (discussing *Hoeper v. Tax Comm'r of Wis.*, 284 U.S. 206 (1931), which invalidated under the due process clause a state statute that applied a single progressive tax schedule to the aggregate income earned by a husband, wife, and children under age 18).

78. Under Internal Revenue Code section 151, the taxpayer may claim one exemption for himself or herself, and an additional exemption for each dependent who does not file a joint return or who is not allowed as a dependent on another taxpayer's return. In general, the taxpayer may deduct the exemption amount for any member of the household whose income is less than that exemption amount, although the exemption amount may be claimed for a child regardless of income through age 18. (The dependency exemption extends until age 24 for a student, which costs the fisc about \$850 million a year; see JOINT COMM., ESTIMATES OF FEDERAL TAX EXPENDITURES, *supra* note 58, at Tbl. 1 (under the category "Education, Training, Employment and Social Services")). Internal Revenue Code sections 151 and 152 (which defines "dependent") delineate the rules in excruciating detail.

79. I.R.C. § 6012(a). In 1992, because of inflation adjustments, the personal exemption was \$2,300 and the standard deduction for a single filer was \$3,600. However, for a taxpayer claimed as a dependent on another's return, the standard deduction is limited to \$500 unless earned income is greater. See I.R.C. § 63(c)(5).



fourteen years old or sixty-four years old, he files no return on his own, but his personal exemption (\$2,300 in 1992) may be claimed on the return of the taxpayer providing his support. Observe that while ignoring small amounts of pin money might be viewed as a sensible result, *no one* pays tax on the \$1,000 of babysitting income. The household benefits from the dependent's entire personal exemption, but bears no tax burden on the dependent's income. By contrast, were the Code to require a dependent instead to file on his own, the household would forfeit the benefit of his personal exemption (the \$1,000 taxable income would be eliminated anyway by his own standard deduction).

One economist recently conducted a study of income earned by children aged fourteen to nineteen; she assumed that fourteen is the age at which children are legally employable under most state laws, and that "most children remain financially dependent on their parents up to 1 year after completing high school."<sup>80</sup> Excluding families with college students, she found that children in two-parent homes contribute an average of just five percent of family income.<sup>81</sup> While the average dollar amount (about \$2,650 in 1990 dollars) falls short of the amount requiring the child to file a tax return, it exceeds the value of the personal exemption that may be claimed by parents. Additionally, in the economic sense, as opposed to the tax-law sense, "comparisons of children's income are difficult to make because informal money transfers within the family, such as allowances and gifts, obscure the money source and are difficult to count."<sup>82</sup> Because our income tax excludes gifts from taxable income,<sup>83</sup> we view the child as a taxpayer only when she participates in the market.

Congress could bring all earnings into the tax system, and also prevent income shifting, by adopting a simple but arbitrary age cut-off or other bright line test for allocating tax effects between parents and children. Like other simple but arbitrary rules, though, this one would often fail to provide the "fair" result. The current rules on the dependency deduction try for such simplicity: a child ceases to qualify as a dependent upon reaching age nineteen, or, if a student, age

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80. Mary A. Noeicker Guadagno, *Impact of Children's Employment on the Economic Status of Two-Parent Families*, 5 FAM. ECON. REV. 9, 11-13 (1992).

81. *Id.* "Results suggest that, unlike in previous generations, children in two-parent families are not employed out of economic necessity. . . . This supports previous research that parents view money as a useful tool for teaching children ethical and social attitudes about the value of saving, budgeting, and planning." *Id.* at 15.

82. *Id.* at 10; see *infra* part I.C.2.

83. I.R.C. § 102.

twenty-four.<sup>84</sup> However, policymakers might perhaps be unaware that, as of the fall of 1990, about forty-four percent of college students are older than twenty-four.<sup>85</sup> Moreover, many students find themselves attending higher education longer than their parents did, either because they take more than four years to finish college or because they pursue more postgraduate schooling.

## 2. *Gift Tax Considerations*

While our income tax excludes gifts, significant gratuitous wealth transfers can be snared by the separate gift and estate tax. A parent can incur gift tax on a transfer to a minor. However, a "gift" requires detached and disinterested generosity.<sup>86</sup> Where a parent bears an obligation to make the transfer under local support law, the transfer constitutes neither income to the child nor a taxable gift by the parent.<sup>87</sup> By contrast, if Mom and Dad pay for their adult daughter's living expenses, the expenditure is treated as consumption by them rather than by the daughter (no deduction by them, but no income to her), potentially subjecting Mom and Dad to the gift tax.

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84. However, Congress must further resolve the allocation of the dependency deduction between two separated, divorced, or unmarried parents. Accordingly, the statute additionally requires the claiming parent to provide over half the support of the child. Senators Moynihan and Packwood recently introduced a bill simplifying the definition of "dependent" and "child" for all purposes of the Code. Tax Simplification for Families Act of 1993, S. 939, 103d Cong., 1st Sess. (1993). This proposal would jettison the support test, and substitute for it a residency test: a parent could claim a personal exemption for any child under age 19 (or 24 if a student) if the child merely lives with the taxpayer for more than half the year. The proponents of this bill appear to inadvertently deprive parents of a deduction for children they support who live on-campus.

85. NATIONAL CTR. FOR EDUC. STATISTICS, U.S. DEP'T OF EDUC., 120 YEARS OF AMERICAN EDUCATION: A STATISTICAL PORTRAIT, Tbl. 24 n.1 (1993).

86. *Commissioner v. Duberstein*, 363 U.S. 278 (1960).

87. *Dickman v. Commissioner*, 465 U.S. 330, 341 (1984) (transfers to minor children in excess of the "necessities and conveniences of life," if in significant quantities, raise gift tax issues); cf. Michael J. McIntyre, *Implications of Family Sharing for the Design of an Ideal Personal Tax System*, in *THE PERSONAL INCOME TAX: PHOENIX FROM THE ASHES* 145, 161 (Sijbren Cnossen & Richard M. Bird eds., 1990) ("The important gifts, for family taxation purposes, are the annual gifts that finance the living expenses of children and spouses earning less than their mate.").

Transfers falling outside the support obligation<sup>88</sup> can often be covered with our comfortably large exclusions for certain gifts.<sup>89</sup> The \$10,000 per year per donee exclusion from the gift tax provides a general cushion.<sup>90</sup> In addition, the Code excludes from the gift tax any payment of tuition made to a qualified educational institution (at any level of schooling), regardless of the relationship between the donor and the beneficiary, thus favoring gifts of human capital over gifts of physical or financial capital.<sup>91</sup>

### 3. Consumption Tax Considerations

Children's influence on family *expenditures* has recently grown, due to the shrinking size of families (increasing each member's role), the delay of parents' childbearing (increasing the amount spent on children), and increasing trends in two-parent workers (seventy-three percent of all wives worked in 1987, sixty-eight percent full-time) and single-parent households (increasing the children's expenditure authority).<sup>92</sup> Most important for our purposes, the College Board's 1992 Annual Survey of Colleges pegged annual out-of-pocket costs for the 1992-93 school year at about \$15,000 for a four-year private college or university and at about \$5,800 at a state school. For the middle fifty percent of schools, annual costs ranged from about \$6,000 to \$11,000 at private institutions and from about \$1,500 to

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88. Much of the debate seems to occur at age 18, or under other principles determining whether one person has the obligation under state law to support another. *See, e.g., Sakovitz v. Sakovitz*, 429 A.2d 1091 (N.J. Super. Ct. 1981) (support obligation generally terminates at age 18, unless the child is incapacitated or, more recently, the child shows scholastic aptitude and the parents can afford to send him to college; however, where four years earlier, upon graduating from high school, the child expressed no desire to go to college, and in reliance the father gave him funds to help him go into business, "extension of this doctrine would create an unreasonable, open-ended burden on parents who, at any stage in their lives, could be called upon to finance a college education"). *See generally* Jay M. Zitter, Annotation, *Postsecondary Education as Within Nondivorced Parent's Child-Support Obligation*, 42 A.L.R. 4TH 819 (1992).

89. *See generally* John G. Steinkamp, *Common Sense and the Gift Tax Annual Exclusion*, 72 NEB. L. REV. 106 (1993).

90. Thus, parents can transfer as much as \$40,000 to their married child (\$10,000 per donor per donee).

91. I.R.C. § 2503(e). However, "[n]o unlimited exclusion is permitted for amounts paid for books, supplies, dormitory fees, board, or other similar expenses which do not constitute direct tuition costs." Treas. Reg. § 25.2503-6(b)(2) (1984).

92. Guadagno, *supra* note 80, at 10 ("[C]hildren influence more than \$132 billion of consumer spending for children's items such as snacks, toys, electronics, clothes, and hobby supplies; housing items such as furniture, televisions, stereos, and yard equipment; and family items such as vacations, automobiles, food, and recreation.").

\$2,800 at public institutions.<sup>93</sup>

Thus, the already murky issues of "who's the taxpayer" under an income tax get positively opaque when we consider a consumption tax scheme. While specific proposals vary, a standard consumption tax basically works like this: receipts minus investment equals consumption. Only consumption gets taxed. The *raison d'être* of a consumption tax is to collect the same present value of tax on the consumption regardless of when the consumption occurs. It achieves this by eliminating the tax on *returns on* investment.<sup>94</sup> In contrast, by taxing investment income, an income tax "double taxes" savings. We are already moving towards financing personal expenditures incurred at the *end* of life on a pretax basis through our multi-trillion dollar private retirement system.<sup>95</sup> Indeed, by one estimate, the United States is already about halfway between an income tax and a consumption tax.<sup>96</sup>

Proponents of a consumption tax argue that a consumption tax can be expected to raise more level amounts over an individual's lifetime, as she consumes before she earns income and after she retires. Under the "permanent income" or "life cycle" theory, we project our expected average annual lifetime income, and then borrow or

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93. Alina Matas, *College Planning 101: It's Never Too Early to Start Saving for Child's Education*, CHI. TRIB., June 24, 1993, § 6, at 1; see also Anthony Flint, *Private Colleges Try Not to Cross the \$100,000 Line*, B. GLOBE, Feb. 25, 1993, at 1 (average annual cost comes to \$12,874 at private four-year institutions who are members of the National Association of Independent Colleges and Universities, but some schools are poised to break the \$25,000-a-year barrier).

94. The generalizable result is that a full deduction of an investment up front is equivalent to exempting the income stream from tax. This holds, true, however, only if (1) the tax rate that would otherwise apply to the amount is the same in all years, (2) taxpayers have no accumulated capital when the consumption tax is enacted, and (3) the taxpayer cannot postpone consumption indefinitely (we have a closed system that treats bequests as consumption). See Michael Graetz, *Implementing a Progressive Consumption Tax*, 92 HARV. L. REV. 1575, 1602 (1979). In addition, the system assumes that (4) taxpayers can borrow and lend risk-free; and (5) all income can be classified as from wages or capital. *Id.* See generally, e.g., Mark Kelman, *Time Preference and Tax Equity*, 35 STAN. L. REV. 649, 674 (1983).

95. See, e.g., Joel Chernoff, *U.S. Pension Assets Reach \$4.4 Trillion*, PENSIONS & INVESTMENTS, Jan. 25, 1993, at 1, 1, available in LEXIS, NEWS Library, PENINV File ("[P]ension assets eclipse the \$4.2 trillion national debt and dwarf the \$1.6 trillion in financial assets held by life insurance companies, \$1.35 trillion held by thrift institutions, \$1 trillion held by mutual funds or \$553 billion held by money market funds.").

96. Don Fullerton et al., *Replacing the U.S. Income Tax With a Progressive Consumption Tax*, 20 J. PUB. ECON. 3, 12-13 (1983) (considering investments in housing, pensions, and life insurance, but not other financial assets such as tax-exempt municipal bonds and not investments in human capital). See analysis in C. David Anderson, *Conventional Tax Theory and "Tax Expenditures": A Critical Analysis of the Life Insurance Example*, 57 TAX NOTES 1417, 1424 (1992). Note particularly one significant failing of the current income tax: about 30% of accrued capital gains escape all income tax via the rule allowing a stepped-up basis to heirs at death. See U.S. TREASURY DEPARTMENT, REPORT TO CONGRESS ON THE CAPITAL GAINS REDUCTIONS OF 1978, at 103 (1985); Donald W. Kiefer, *Lock-In Effect Within a Simple Model of Corporate Stock Trading*, 43 NAT. TAX J. 75, 81 (1990).

save the difference each year in order to smooth consumption.<sup>97</sup> While economists agree that lifetime income follows a hump-shaped distribution (which peaks sometime in middle age),<sup>98</sup> they disagree about how much consumption smoothing people can or are willing to do.<sup>99</sup> The life cycle theory deals inadequately with the practical problem that if we have to dissave when we are young, before we've earned income, where do we get the cash from to finance these expenditures? An accurate consumption tax depends on the perhaps fatal assumption that "[t]here exists a perfect capital market with no uncertainty; all taxpayers can borrow and lend unlimited amounts at a risk-free interest rate."<sup>100</sup> Moreover, a consumption tax does not help our perception that those with high "nondiscretionary" or socially desirable expenditures should not have to bear tax on those expenditures.<sup>101</sup>

97. For the permanent income theory, see MILTON FRIEDMAN, *A THEORY OF THE CONSUMPTION FUNCTION* (1957); for the life cycle theory of saving and consumption, see Modigliani, *supra* note 50.

98. See part I.D for a discussion of the lifetime income pattern.

99. Compare Modigliani, *supra* note 50, at 15 with Laurence J. Kotlikoff, *Intergenerational Transfers and Savings*, 2 J. ECON. PERSP. 41 (1988) and Cutler, *supra* note 38, at 64 ("[C]hanges in consumption appear far too sensitive to changes in income for the life cycle model [of consumption smoothing] to be correct.") and DON FULLERTON & DIANE L. ROGERS, WHO BEARS THE LIFETIME TAX BURDEN? 163 (1993) (people tend to prefer rising consumption with age) and William J. Wiatrowski, *Factors Affecting Retirement Income*, MONTHLY LAB. REV., Mar. 1993, at 25, 27 (the elderly reduce their consumption after retirement, according to data from the Bureau of Labor Statistics' Consumer Expenditure Survey).

100. Stephan, *supra* note 62, at 1367 n.17; see ROSEN, *supra* note 39, at 472; Zeldes, *supra* note 6; Hansen, *supra* note 6; see also BRADFORD, *supra* note 3, at 165 ("It may be objected that . . . it is preferable to have the earnings early in life. This objection really expresses the inadequacy of the assumption . . . that [one who earns more early in life and another who earns more later in life] have the same consumption opportunities by virtue of their ability to borrow and lend in the capital market."); cf. 2 W. SOMERSET MAUGHAM, *The Ant and The Grasshopper*, in *THE COMPLETE SHORT STORIES OF W. SOMERSET MAUGHAM* 486 (1952). Maugham wrote:

When I was a small boy I was made to learn by heart certain of the fables of La Fontaine . . . Among those I learnt was *The Ant and the Grasshopper*, which is devised to bring home to the young the useful lesson that in an imperfect world industry is rewarded and giddiness punished. . . .

. . . My sympathies were with the grasshopper and for some time I never saw an ant without putting my foot on it.

*Id.*

101. See, e.g., Michael J. Graetz, *Revisiting the Income Tax vs. Consumption Tax Debate*, 57 TAX NOTES 1437, 1442 (1992). Graetz explains:

In thinking about abandoning the income tax in favor of consumption taxes, we should avoid the trap of comparing the real income tax that we now know with an ideal consumption tax that we might imagine. Consumption taxes, just like income taxes, inevitably will be subject to the same kinds of political pressure

The paradigm of a slightly hump-shaped consumption curve over time, however, obviously depends on allocating early-life expenditures of children to their parents. You would see quite different consumption-age curves if early-life expenditures "belong to" the child rather than to the parents. Who is the consumer when the hospital presents its bill to the new parents, the infant or the parents? Is the difference between college and day care one of kind or merely of degree?<sup>102</sup> In sum, does a new taxpayer come into being under a consumption tax earlier than under an income tax? If not, why not?

Scholars typically focus on eliminating impediments to saving for consumption later in life.<sup>103</sup> Think of a couple who wants to put away a little bit each year in order to finance that larger house, their kids' college education, their parents' old age, and their own old age.<sup>104</sup> If people's earning and spending patterns fit this paradigm, the pure consumption tax model might be "fairer" than the income tax model, which taxes investment income when earned. By contrast, if we allocate costs of raising a child to that child, we would front-load many expenditures. While studies do discuss expenditures of various age groups, few have focused on how to allocate expenses of children between the child and the parents.<sup>105</sup> Most notably, Franco Modigliani and Laurence Kotlikoff debated whether to adopt an age cutoff (such as eighteen), or instead to assign consumption between parent and child based on custom (including parental expenditures

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for favored or punitive treatment of one sort or another.

*Id.* See discussion of the consumption tax treatment of education expenditures in part I.E.

102. I am sure many parents have long harbored notions of keeping tabs on the financial burden their child has imposed, to present to a now-rebellious teenager. A study 10 years ago calculated that a family of four (with the mother working part-time) spends \$82,400 to raise each child to 18, and \$100,000 if you add in a public college. Longman, *supra* note 38, at 80 (study by Thomas Espenshade, for the Urban Institute (figures are in 1981 dollars)).

103. See, e.g., JOHN B. SHOVEN, RETURN ON INVESTMENT: PENSIONS ARE HOW AMERICA SAVES 56 (1991); Albert Ando & Franco Modigliani, *The "Life Cycle" Hypothesis of Saving: Aggregate Implications and Tests*, 53 AM. ECON. REV. 55 (1963); Kotlikoff, *supra* note 50; Edward J. McCaffery, *Tax Policy Under a Hybrid Income-Consumption Tax*, 70 TEX. L. REV. 1145 (1992); Lawrence H. Summers, *Capital Taxation and Accumulation in a Life Cycle Growth Model*, 71 AM. ECON. REV. 533 (1981).

104. See James J. Heckman, *A Life-Cycle Model of Earnings, Learning, and Consumption*, 84 J. POL. ECON. S11, S31-S32 n.15 (1976) (citations omitted) ("[D]ata reveal that family consumption tends to peak and decline after the head reaches the early fifties. . . . If children are more goods intensive as they age, as seems plausible, cross-section peaks in consumption . . . can be explained by the variables family size and age of children. . . .").

105. See, e.g., Daniel T. Slesnick, *Gaining Ground: Poverty in the Postwar United States*, 101 J. POL. ECON. 1 (1993). Prior to the 1980s, the Bureau of Labor Statistics's Consumer Expenditure Survey treated expenditures of college students as expenditures of their parents. *Id.* at 7 n.10. Over one-third of dissavers fell into the 16-24 age group in the 1980s, suggesting that this group has access to credit. *Id.* at 31-33.

for a child's college tuition).<sup>106</sup> The fact that a large tax bill for young people would not be popular suggests that Congress, should it adopt a consumption tax, would at worst track the dependency deduction for allocating consumption.

#### D. Annual vs. Lifetime Measures of Income

For a government program that provides different levels of benefit depending on financial need (such as student aid), fair use of government resources depends on our ability to separate the needy from the non-needy. We face similar problems on a broader scale — which we handle no better — in our tax system. As we search for rules that identify an individual's financial well-being, separating one person from another is only the first step. In applying "horizontal" equity (that is, identifying taxpayers in similar situations) and "vertical equity" (that is, identifying taxpayers in different situations), we often fail to recognize that the same individual passes through several stages of ability to pay tax in his lifetime.

For good reasons, we have an annual accounting and tax collection system.<sup>107</sup> But we also impose a progressive rate scale on annual income in order to achieve vertical equity, on the theory that those with increasing incomes have increasing abilities to pay. Because of the life cycle pattern of income, a taxpayer will likely face lower marginal tax rates early in her career and higher ones later.<sup>108</sup> Thus, a young or old middle-class individual might appear to have the same ability to pay as a forty-five-year-old low-income individual. Is it fairer instead to look beyond our annual fiction to a concept of "lifetime ability to pay"?<sup>109</sup> Ideally, we might have an income tax

106. Compare Kotlikoff, *supra* note 99, at 47 (describing work with Lawrence J. Summers that "treats all payments, either in cash or in kind (including tuition payments), received from parents by children above age 18 as an intergenerational transfer. Support of children prior to age 18 is considered consumption by the parent.") with Modigliani, *supra* note 50, at 31 ("And why should the line . . . not include all expenditure on children? . . . I submit that no customary expenditure on dependents [regardless of their ages] should be treated as a transfer.").

107. *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359, 365 (1931) ("It is the essence of any system of taxation that it should produce revenue ascertainable, and payable to the government, at regular intervals.").

108. We should not forget that for many taxpayers, payroll taxes take a larger bite than income taxes. See, e.g., Brazaitis & Washington, *supra* note 28, at C1 ("[W]hen the employer's share of Social Security tax is counted, 90% of workers under 30 already pay more in FICA taxes than in income taxes."). Thus, our tax system as a whole is less progressive than just our income tax, although the disproportionate distribution of Social Security retirement benefits to formerly lower-income workers somewhat offsets this.

109. Congress used to provide a mechanism for "income averaging" over a multi-

whose period equals the taxpayer's lifetime — wait until the taxpayer dies, tote up all of the income and all of the allowable expenses, throw in an interest factor if you want,<sup>110</sup> and collect the right amount of tax from the estate.<sup>111</sup>

While totally impractical and intrusive, a deathbed lookback would enable policymakers to resist granting tax deductions for personal expenditures that disproportionately burden ability to pay in a particular year, such as extraordinary medical expenses. Current law poorly distinguishes between those personal deductions allowed because they properly measure income and those deductions allowed because the public views it as unfair to extract tax from someone incurring certain “nondiscretionary” expenditures at a particular time in the taxpayer's life.<sup>112</sup>

As a narrow example of the use of rates, why do we allow a credit for child care expenses?<sup>113</sup> It could be argued that without this expenditure, the second spouse could not reenter the job market, and

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year period, but the 1986 Tax Reform Act swept this away on the theory that substantially flat rates made “bunching” of income less distortional. Prior to the repeal, Congress found itself enacting ever stricter rules to prevent newly minted college graduates from claiming the benefits of the technique by including their low-income school years in the base period. See generally Richard Schmalbeck, *Income Averaging After Twenty Years: A Failed Experiment in Horizontal Equity*, 1984 DUKE L.J. 509.

110. Cf. I.R.C. § 7519 (required payment for certain partnerships and S corporations operating under taxable years that excessively defer income).

111. Cf. *Sanford & Brooks*, 282 U.S. at 365 (the vagaries of annual income or loss afford no reason “for postponing the assessment of the tax until the end of a lifetime, or for some other indefinite period, to ascertain more precisely whether the final outcome of the period, or of a given transaction, will be a gain or a loss”). For the conditions under which an income tax collected at death is the same as a consumption tax, see Graetz, *supra* note 94; see also Alvin Warren, *Would a Consumption Tax be Fairer Than an Income Tax?*, 89 YALE L.J. 1081, 1101-12 (1980). For the difficulties of calculating the proper accrual of income over a lifetime of uncertain changes in asset value, see Jeff Strnad, *Periodicity and Accretion Taxation: Norms and Implementation*, 99 YALE L.J. 1817 (1990) and David J. Shakow, *Taxation Without Realization: A Proposal for Accrual Taxation*, 134 U. PA. L. REV. 1111 (1986).

112. Compare William D. Andrews, *Personal Deductions in an Ideal Income Tax*, 86 HARV. L. REV. 309, 334 (1972) (asserting that because the taxpayer is no better off than if he had been healthy all along, income earned to pay medical expenses should not be viewed as income at all) with Mark G. Kelman, *Personal Deductions Revisited: Why They Fit Poorly in an “Ideal” Income Tax and Why They Fit Worse in a Far From Ideal World*, 31 STAN. L. REV. 831, 865-71 (1979) (disagreeing, on the ground that we all have different circumstances, and it is difficult to say when an expense restores us to some ideal level of health and when it represents an element of consumption).

113. Internal Revenue Code section 21 allows single persons and married couples (generally, only where both spouses are employed) a non-refundable tax credit on child care expenditures of up to \$2,400 for one dependent (\$4,800 for two or more). Many of the costs of child care currently escape the market, but as more women enter the labor market they leave fewer behind to provide informal care. Rachel Connelly, *The Effect of Child Care Costs on Married Women's Labor Force Participation*, 74 REV. ECON. & STAT. 83, 90 & n.17 (1992) (“We have already seen a decline in relative care and an increase in center based care from 1977 to 1985 . . .”).



so child care properly qualifies as a cost of doing business.<sup>114</sup> However, the credit phases down (but is not eliminated) for higher income levels.<sup>115</sup> Thus, Congress currently does not view child care costs purely as affecting the question of income, but rather more as a question of rate (although it is debatable how progressive this credit is).<sup>116</sup> Congress does not think it is fair that middle-income working parents with child care expenses should pay for those expenses out of after-tax income.<sup>117</sup> But over their lifetimes, the young, middle-income parents could turn out to have been quite successful income-earners after all. If they cannot afford the full costs of child care, then who can?<sup>118</sup>

The distortion created by our annual accounting system cannot be overstated. Looking at tax return filings, we can say with assurance that a particular class of "low-income" taxpayers — those earning \$10,000, say — are not homogeneously "poor."<sup>119</sup> Lurking in that

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114. Indeed, this was the stated rationale. Note that, except for students and incapacitated parents, the credit cannot exceed the income earned by the spouse with the lower income. I.R.C. § 21(d).

115. The credit equals 30% of employment-related child-care expenses for those with adjusted gross income (AGI) of up to \$10,000; it phases down to 20% percent at AGI of \$28,000. *Id.* § 21.

116. See PECHMAN, *supra* note 68, at 97 ("In practice, the child care credit is not very helpful to low-income people, because families at these levels cannot afford such outlays. In 1984 two-thirds of the \$2.6 billion deducted as a child care credit was reported by taxpayers with adjusted gross incomes of more than \$20,000.").

117. Indeed, because our income tax system does not impute income from self-supplied labor, it generally subsidizes families having a member who does not work for someone else. Compare, for example, Mother *A* who earns \$20,000 from work as a travel agent. She incurs day care expenses for her infant of \$400 a week for 50 weeks, for a total annual expense of \$20,000. Mother *B* does not participate in the labor force, but rather stays home for a year to care for her infant. Each mother brings in the same net economic benefit to the household *that year* (\$0). However, ignoring the child care credit, *A* must pay income tax on her earnings. (Notice, too, that so must the person hired by *A* to care for her infant.) The child care credit helps rectify the nontaxation of self-performed services. Women in jobs with little potential for advancement generally compare only current income and expenses. If, however, *A* in my example were on a professional track, she might be making a sound economic decision to spend her entire current income on child care even in the absence of a credit under the view that her additional income tax constitutes an investment in not interrupting her career. See McCaffery, *supra* note 68, at 1023 n.156.

118. As with so many other tax exclusions for employer-provided benefits, mothers who are professionals are also more likely than production and service workers to be offered child care benefits, particularly pretax spending accounts (the so-called "cafeteria plans" under Internal Revenue Code section 125). Beth Miller, *The Distribution of Family Oriented Benefits*, 130 EMPLOYEE BENEFIT RES. INST. ISSUE BRIEF 1 (1992).

119. Every year the Internal Revenue Service reports on filers who declare income of \$200,000 but, because of deductions, credits and tax-exempt bond interest, no tax liability. While such stories make dramatic reading, the numbers are small. For 1990,

group, for example, is a significant number of young people just starting their working lives, as well as many comfortable elderly, living off savings.<sup>120</sup> No doubt without meaning to, "a progressive annual tax structure generates heavier burdens on individuals with more humped lifetime income profiles, all else equal."<sup>121</sup>

Economists and the popular press publicly slugged out this "annual versus lifetime" income debate during a recent examination of who won and who lost from the Reagan tax policies.<sup>122</sup> Distributional analysis — usually conducted to study who bears the burden of tax changes — presents two types of difficulties. First, our definition of taxable income (and therefore tax return data) fails to capture all financial resources.<sup>123</sup> (In this respect, at least, the current student aid financial-needs tests might be ahead of the tax system, because these tests look to some nontaxable sources of income as well as taxable income in assessing the borrower's or family's resources.)<sup>124</sup> Second, the annual accounting system fails to properly identify "income mobility," the movement of the same individuals up

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the figure was 779 couples or individuals (earning a total of \$340 million), which represented one-tenth of one percent of taxpayers at that income level; an additional 8020 returns paid tax at less than a 5% effective tax rate; and 15,246 paid tax at a 5-10% effective rate. See *More Rich Americans Escape Tax*, CHI. TRIB., June 30, 1993, § 1, at 4.

120. Retirees might own their own houses, receive nontaxable Social Security payments, and enjoy Medicare benefits. For example, in 1990 "60 percent of U.S. households headed by individuals aged 65 to 74 owned their own homes without a mortgage," compared with 24% of the entire population. Wiatrowski, *supra* note 99, at 27. See generally FULLERTON & ROGERS, *supra* note 99, at 18, 26 (based on a theoretical redefinition of income, "only 21.1 percent of individuals in our sample are in the same annual and lifetime income deciles [one-tenth of the population], and only 46.1 percent are within plus-or-minus one of the same decile").

121. FULLERTON & ROGERS, *supra* note 99, at 19.

122. For a sample of the recent salvos, see STAFF OF THE JOINT COMM. ON TAXATION, PUB. NO. JCS-7-93, *METHODOLOGY AND ISSUES IN MEASURING CHANGES IN THE DISTRIBUTION OF TAX BURDENS* (Joint Comm. Print 1993); Paul R. Krugman, *The Right, The Rich, and the Facts: Deconstructing the Income Distribution Debate*, 11 AM. PROSPECT 19, 29 (1992); Office of Tax Analysis, U.S. Treasury Dep't, *Household Income Mobility During the 1980's: A Statistical Assessment Based on Tax Return Data*, June 1, 1992, at n.10, available in LEXIS, FEDTAX Library, TNT File as 92 TNT 113-1; Sylvia Nasar, *The 1980's: A Very Good Time for the Very Rich*, N.Y. TIMES, Mar. 5, 1992, at A1.

123. See, e.g., Feenberg & Poterba, *supra* note 74, at 147 ("For studying the distribution of incomes below the top tier, tax returns are not the best source of information. Not all low-income households file tax returns, and even for those who do, tax returns do not include information on most transfer payments."). In preparing tax distributional analyses, estimators routinely add certain nontaxable items back into the base. See JOINT COMM., *ESTIMATES OF FEDERAL TAX EXPENDITURES*, *supra* note 58; STAFF OF WAYS AND MEANS COMM., 102d Cong., 2d Sess., *OVERVIEW OF ENTITLEMENT PROGRAMS* (Comm. Print 1992); cf. Slesnick, *supra* note 105, at 19, 30-31 (because of in-kind benefits such as housing subsidies and health care, consumption-based poverty rates are much lower than income-based poverty rates; additionally, about 40% of the "income poor" are homeowners, compared with 60% for the entire sample, and most poor enjoy significant "service flows" from other consumer durables).

124. See part II.B.

and down the income distribution spectrum over the years.<sup>125</sup>

The life cycle of income phenomenon teaches us that early dis-saving will likely be outweighed by future earning — or it would, if only young people had the money to dissave. Indeed, in its purest form, an investment in human capital through full-time postsecondary schooling can require foregoing all current income.<sup>126</sup> In sum, for most students it is a problem of timing.

### *E. Tax Treatment of Education Expenses*

#### *1. Economic and Tax Treatment of Education*

Aside from direct government aid, whether through grants or loans, our tax system also affects a student's (or family's) financial decision to invest in a college education. Surprisingly, perhaps, we find that our current tax rules *disfavor* expenditures for most formal higher education. A tax system will induce economic distortions if it fails to treat economically equivalent transactions equivalently; in this case, we focus on two comparisons:

- The treatment of an investment in human capital and an investment in physical or financial capital.
- The treatment of education purchased out of savings (that is, out of past reduced consumption) and education purchased with borrowed funds (that is, out of future reduced consumption).

To illustrate the rules to follow, let's use an example. For simplicity, assume a two-period model: Sam wants to go to college for only one year, and Sam will thereafter work for only one year. The cost of tuition, books and fees will be \$10,000, payable on the date of enrollment. Of course, Sam also will have living expenses, but he would anyway; by the same token, Sam would otherwise have earned income during the period he attends school. For now, ignore these nondeductible living expenses and the untaxed forgone income. Sam figures that he would have earned \$20,000 a year just with his high

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125. See, e.g., MILTON FRIEDMAN, CAPITALISM AND FREEDOM 171 (1962) (describing this "kind of inequality [as] a sign of dynamic change, social mobility, equality of opportunity"); Gene Steuerle, *Income Mobility*, 56 TAX NOTES 1369, 1369 (1992) ([T]he . . . studies remind us forcefully of just how weak are annual measures of income. . . . If we use a one-day accounting period, for instance, most of us are probably in the ranks of the poor on Sundays . . . while we appear rich on those lucky days when . . . a substantial check comes in the mail").

126. Moreover, a student may even jeopardize the "investment" by working too many hours during the school term. See discussion of forgone income as a cost of education *infra* Part I.E.1(a).

school diploma, and that he will earn an additional \$12,000 a year with his college degree. That is, in year two Sam expects a twenty percent rate of return on his direct \$10,000 investment made in year one.

*a. Cost recovery*

Even before we ask where he is getting the money from to finance his education, let us ask whether the tax rules produce a fair deal for Sam. While an investment in physical capital generally gives rise to an asset whose cost may be recovered over its useful life through tax deductions, no such amortizable asset results under current law from human capital investments.<sup>127</sup> As a general rule, taxpayers cannot deduct personal living expenses.<sup>128</sup> Any hope for a deduction for education rests with section 162 of the Internal Revenue Code, which allows deductions for business expenses. For all intents and purposes, however, we can fairly assume that the Internal Revenue Service will not allow a deduction for pre-employment expenses for education and training.<sup>129</sup> Nevertheless, as Professor Paul Stephan puts it: "It is man's tragic fate that a finite life bounds human capital, and our system normally makes allowances for wasting assets."<sup>130</sup> A straight-line amortization of a college education over, say, a forty-year expected working life might fail to match income to expense accurately,<sup>131</sup> but it does a better job than denying cost recovery entirely. Many economists and scholars have called for legislative change to conform the tax treatment of human and nonhuman investment by allowing some sort of cost recovery deduction for investments in education.<sup>132</sup>

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127. Unless you are talking about an investment in someone *else's* human capital. See, e.g., Stephan, *supra* note 62, at 1361 ("The market in baseball player contracts, for example, works as most markets do."); see also *Selig v. United States*, 740 F.2d 572 (7th Cir. 1974); cf. JEFFREY H. BIRNBAUM & ALAN S. MURRAY, *SHOWDOWN AT GUCCI GULCH: LAWMAKERS, LOBBYISTS, AND THE UNLIKELY TRIUMPH OF TAX REFORM* 26 (1987) (quoting Senator and former National Basketball Association star Bill Bradley) ("Mr. President [Reagan], you came to this [tax reform] because you were an actor who paid at the 90-percent rate. . . . I came to this because I was a depreciable asset.").

128. I.R.C. § 262(a). The return on the personal or social aspect of education includes numerous psychic benefits, such as enhanced prestige, heightened intellectual pleasure, and good citizenship.

129. See Treas. Reg. § 1.162-5 (as amended in 1967).

130. Stephan, *supra* note 62, at 1371.

131. Those scholars who object to creating a deduction for costs of college education properly observe that the enhanced future income stream bears no necessary relationship to the out-of-pocket expenses of a particular student. See, e.g., John K. McNulty, *Tax Policy and Tuition Tax Credit Legislation: Federal Income Tax Allowances for Personal Costs of Higher Education*, 61 CAL. L. REV. 1, 30-32 (discussing the difficulties of tying a cost recovery deduction for education costs to type and timing of income earned).

132. See, e.g., Schultz, *supra* note 52, at 13 ("Although . . . it is obvious that human capital, like other forms of reproducible capital, depreciates, becomes obsolete,

The matter is not so simple, however. To adopt a proper economic approach, we would have to establish that the student's expenditures for college education should be treated like any other investment in an asset that will produce future income. Because of the "diploma premium" discussed above, at least a portion of the costs of higher education qualify as investment.<sup>133</sup> This does not establish, however, that any *particular* cost can properly be assigned to the investment component of an education. Many of the inputs to human capital escape tax, such as subsidized tuition at a state college. A major untaxed input comes from a student's forgone earnings during the period he or she is in school.<sup>134</sup> On the other hand, the current regulation's disallowance for minimum education requirements exceeds even a disallowance for the personal elements of a college education.<sup>135</sup> Thus, for example, if half of the inputs to an education escape tax and half of the benefits of college are enhanced present or

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and entails maintenance, our tax laws are all but blind on these matters." Professor Schultz's comment on maintenance is not true — Treasury Regulation section 1.162-5 (as amended in 1967) does permit on-the-job training costs or other continuing education costs to be deducted as business expenses. See also BRADFORD, *supra* note 3, at 205. Most recently, see David S. Davenport, *Education and Human Capital: Pursuing an Ideal Income Tax and a Sensible Tax Policy*, 42 CASE W. RES. L. REV. 793 (1992) and Loretta C. Argrett, *Tax Treatment of Higher Education Expenditures: An Unfair Investment Disincentive*, 41 SYRACUSE L. REV. 621 (1990).

133. Schultz, *supra* note 52, at 8. Because the mixed investment-consumption feature of education makes it difficult to apply the cost method of estimating the amount of an investment in human capital, the alternative yield method works better: "In principle, the value of the investment can be determined by discounting the additional future earnings it yields just as the value of a physical capital good can be determined by discounting its income stream." *Id.* at 8 & n.5.

134. See, e.g., *id.* at 11 ("In the United States, for example, well over half of the costs of higher education consists of income foregone by students."). The fact that a young person's forgone *pretax* income is generally low explains why young people can "afford" to make investments in time-intensive education in the first place. GARY S. BECKER, *HUMAN CAPITAL: A THEORETICAL AND EMPIRICAL ANALYSIS, WITH SPECIAL REFERENCE TO EDUCATION* 100-01 (2d ed. 1975). The progressive rate structure, among other features, led Professor Stephan to conclude that our current income tax system does not much disfavor investments in human capital as compared with physical capital, because the forgone income that should properly be taxed and the out-of-pocket tuition that should be deductible offset each other. However, he observed that a taxpayer might want it the other way around: "If acquisition of human capital normally takes place in earlier years when total earning power is low, and its amortization occurs in later, high earning years, then the tax savings of the exclusion might be small and the loss of amortization deductions might be costly." Stephan, *supra* note 62, at 1371.

135. See, e.g., RICHARD A. MUSGRAVE & PEGGY B. MUSGRAVE, *PUBLIC FINANCE IN THEORY AND PRACTICE* 216 (3d ed. 1980) (assuming "the cost of educational inputs is divided equally between earnings and psychic income-generating investment. . . . [and] both yield equal returns, the income stream (monetary and imputed) would be doubled"); see also Schultz, *supra* note 52, at 13 ("If one were to allocate a substantial fraction of the total costs of this education to consumption, say one-half, this would, of

future enjoyment of life, how do we “stack” the taxed and untaxed amounts between deductible and nondeductible costs? Just to simplify the discussion, I assume that the out-of-pocket costs of tuition, fees and books can be properly viewed as spent for investment, and the untaxed inputs are spent on consumption, but other allocations might more clearly reflect income.<sup>136</sup>

Without any deduction for cost recovery, then, is Sam’s rate of return really twenty percent (\$12,000 income minus \$10,000 investment)? Let us say that instead of going to college he bought an asset which he sells for \$12,000 at the end of year two. The tax treatment of that transaction exhibits one crucial difference with an investment in education: Sam’s \$10,000 basis in the asset will not be taxed to him again. He thus pays tax on \$20,000 from wages and \$2,000 investment profit (\$12,000 minus \$10,000). By contrast, when Sam earns \$32,000 from his higher salary, he pays tax on the entire \$32,000. He is taxed on the return *of* his investment, not just on the return *on* his investment. By going to college, assuming a thirty percent income tax rate, Sam pays \$3,600 on the additional \$12,000 salary — a negative return on his investment. He would have been better off in year two just earning a \$20,000 salary with his high school diploma.

We can use the investment analysis just described to understand the circumstances under which it is fair to require students (or their families)<sup>137</sup> to repay government subsidies for education. As Professor Bradford says, “Unless the tax system results in the government’s sharing equally in the cost and the return, it will affect the profitability of such investments.”<sup>138</sup> If, for example, the federal government paid for Sam’s education, he is fairly taxed on the entire \$12,000 return *because his basis in his investment is zero*. This is indeed the tax result for those who receive tuition scholarships,<sup>139</sup> or, indeed, for those who attend public elementary and secondary

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course, double the observed rate of return. . . . A change in allocation only alters the rate of return, not the total return.”).

136. As noted in footnote 134, *supra*, Professor Stephan is not much troubled by deduction disallowance, because the untaxed forgone income and the nondeductible tuition offset; however, this method of allocation no more clearly reflects income than a full deduction. In no event, though, should the student’s living expenses qualify as investment. See Theodore W. Schultz, *Capital Formation by Education*, 68 J. POL. ECON. 571, 573 (1960).

137. Were parents to pay for the child’s education, see *supra* part I.C for a discussion of whose cost recovery expenditures these would be. Cf. Davenport, *supra* note 132, at 820-21 n.66 (suggesting that where the parent would otherwise have paid for the education, a cost recovery deduction be calculated at the parent’s (higher) tax rate, “as is done with the ‘kiddie tax’”).

138. BRADFORD, *supra* note 3, at 205 (the government shares in the cost of education when the student finances it through fewer hours worked, because of the lost tax on the forgone wages).

139. See generally Charlotte Crane, *Scholarships and the Federal Income Tax*

schools (although the reason usually given is that lower education produces primarily social returns).<sup>140</sup> Presumably, if we allowed cost recovery deductions for education, the graduate's amortizable basis would include only out-of-pocket costs, and not untaxed inputs such as grants, scholarships, reduced tuition, or forgone income. Because an exclusion from income generally has the same tax effect as an inclusion accompanied by an immediate deduction,<sup>141</sup> this model actually accelerates the benefit to the graduate. However, taxing these inputs without allowing any cost recovery deduction for appropriate costs would expand the amount of mismeasured human capital investment. The most accurate result is one that matches the amortization of education costs to the projected income stream. This accuracy could be attempted only by imputing to Sam the costs of government-provided education and allowing him to recover the imputed amount over time.

What would be the tax treatment of college expenses if instead we had a consumption tax instead of an income tax? Many consumption tax proposals include exemptions for such "necessities" as food, clothing, housing, and medical expenditures.<sup>142</sup> Surprisingly, there is little academic discussion of how to treat education in a consumption tax.<sup>143</sup> Again, if we view education as consumption, educational expenditures would not reduce the tax base. However, if education qualifies as investment, then the expenditure would be immediately expensed.

A consumption tax that provides no deduction for college education costs suffers from an additional problem. The expenditure of the amounts (and we can be talking about very large amounts) will be

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Base, 28 HARV. J. ON LEGIS. 63 (1991); Joseph M. Dodge, *Scholarships Under the Income Tax*, 46 TAX LAW. 697 (1993).

140. See, e.g., FRIEDMAN, *supra* note 125, at 86-98 (of course, Friedman expresses skepticism of even the benefits of collectively producing good citizens). But see BECKER, *supra* note 134, at 201-05 (comparing personal and social rates of return to a high school education).

141. Nothing is simple anymore. The 1986 Tax Reform Act imposed a "2-percent floor" on miscellaneous employee business expenses. I.R.C. § 67. If attending school is viewed as an expense of future employment, then the amortization deductions would come under this floor.

142. See, e.g., Graetz, *supra* note 101, at 1441.

143. For the fullest treatment, see Stephan, *supra* note 62, at 1375. See generally BRADFORD, *supra* note 3, at Tbl. 14-1 (setting forth the alternatives of education costs in a "limited-exemption" consumption tax base or a "liberal-exemption" base; the difference in 1981 dollars is \$29.3 billion annually for the aggregate category "private education and research"). See also Heckman, *supra* note 104.

subject to current tax in the year spent. And if we retain a progressive rate structure, an expenditure this size is likely to tip the student into the highest bracket! This is a problem of, as Professor Bradford puts it, "lumpiness."<sup>144</sup>

Moreover, a consumption tax does not care where the taxpayer gets the money from to spend on consumption. The money could come out of earned income. It could come out of returns on investment or out of savings. And, what may be taken as a nasty surprise, the money could come from *borrowing*.<sup>145</sup> (Gifts and inheritances present an additional layer of issues, with no consensus by the scholars.) For a similar "lumpy" nondeductible expenditure — the purchase of a home — Professor Bradford offers the possibility of excluding the mortgage borrowing (and repayments) from the consumption tax base.<sup>146</sup> A similar mechanism could be adopted for student loans. However, unless we also adopt a general averaging device, we might then produce a more favorable result for borrowing than for tuition paid out of savings (or current income).

### *b. Interest*

The other substantive issue in the taxation of education is the timing of the expenditure. Sam will be subject to the same tax treatment for his investment (after conforming the cost recovery rules) only if he comes out the same by paying for his college education with cash on the barrelhead (i.e., from money already saved) or by repaying student loans (i.e., from money to be saved in the future).

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144. See BRADFORD, *supra* note 3, at 85-86 (discussing mortgages).

145. During the lead up to the 1986 tax reform, Treasury Secretary Donald Regan told his Assistant Secretary for Tax Policy, Ron Pearlman: "The next time you go to a cocktail party, you ask people what they think of a tax system in which borrowings are treated like income. They're going to tell you you're crazy." BIRNBAUM & MURRAY, *supra* note 127, at 52; see also William D. Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113, 1154 (1974) ("Inclusion of loan proceeds in income would not ordinarily require large tax payments in the year of a loan, because normally such loans are to pay for capital investment that would be immediately deductible under a consumption-type tax."). The overtaxation problem does not show up so clearly under our current income tax — not because college tuition is deductible but because the tax liability is masked by being matched to the repayment term of the loan. That is, after the student enters the workforce and begins to repay the loan, he makes each payment with income taxed to him that year.

146. BRADFORD, *supra* note 3, at 85-86. Bradford explains:

Two methods are available to alleviate the tax consequences of applying graduated rates to such wide swings in the tax base. Some form of tax base averaging . . . may be introduced. Or special allowance may be provided for tax-prepaid treatment of mortgage borrowing (no inclusion of proceeds, no deduction for repayments of principal or interest). In addition, limited tax-prepaid savings might be allowed (for example, a special homeowner's saving plan, with no deduction for amounts put aside but no taxation of the returns or of any withdrawals from the plan).

*Id.* at 86.



However, our current income tax does not produce parity here.<sup>147</sup>

First, assume Sam saved \$10,000 prior to going to school. This amount has already borne tax. By spending the funds on schooling, Sam loses the ability to earn a return on an alternative investment of the funds. We properly measure this opportunity cost after tax. That is, if Sam had instead bought a T-bill bearing a ten percent return, his \$1,000 return would have been taxed to him. Assume a thirty percent tax rate, Sam would have \$700 cash after one year if he didn't go to college. Thus, by going to college, Sam gave up the ability to consume an additional \$700. If instead Sam borrows the funds, at a ten percent interest rate, he will have to repay the loan plus interest. Again, the income he earns to repay the \$10,000 principal will be subject to tax. However, so will the income he earns to pay the interest, because, after the 1986 Tax Reform Act, interest paid on consumer loans (including education loans) cannot be deducted.<sup>148</sup> If he could have deducted the \$1,000 interest payment he would have saved \$300 in taxes on the income earned to finance the interest repayment, and thus would have lost the ability to consume only \$700. By being denied the deduction, Sam's future consumption is reduced by the full \$1,000.

The denial of an interest deduction distorts the choice between spending out of prior saving or spending out of future saving.<sup>149</sup> Where the interest payment cannot be deducted,<sup>150</sup> we reward taxpayers who save first, spend later.

Unfortunately, this is not the end of the story. We do allow a home mortgage interest deduction, and, of course, money is fungible. Thus, we now live under the absurd and terribly unfair regime that a taxpayer who owns a home can generally deduct interest paid on a "home equity loan" — regardless of what he does with the proceeds.<sup>151</sup> Meanwhile, his renting counterpart must borrow for these

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147. The following example is based on LOUIS A. TALLEY & BOB LYKE, CONGRESSIONAL RES. SERV., PUB. NO. 92-2782, TAX ALLOWANCE FOR INTEREST PAYMENTS ON EDUCATIONAL LOANS: DATA AND DISCUSSION OF ISSUES (1992), *available in* LEXIS, FEDTAX Library, TNT File *as* 92 TNT 71-20.

148. I.R.C. § 163(h).

149. This is as true for expenditures on consumption as for business expenditures; the real distortion under our income tax system is that we do not impute income from the services flows of houses and other consumer durables.

150. Subsidized interest rates offered under a government program of general availability do not result in taxable income to the borrower. Temp. Treas. Reg. § 1.7872-5T(b)(5) (1986). This is equivalent to including the forgone bargain interest in the borrower's income and allowing an offsetting deduction.

151. While Internal Revenue Code section 163(h)(3)(C) places a \$100,000 cap on qualifying home equity debt, this amount would cover four years of expenses (including

expenses on an after-tax basis. Precise figures are not available, but estimates of home equity borrowing for education range from ten to fifty percent of total home equity loans.<sup>152</sup>

Instead of conforming the tax treatment of current and future reduced consumption by granting an interest deduction, we could conform the treatment by excluding Sam's interest earned from income and retaining deduction disallowance. This would give him the choice between \$1,000 cash now or later. This is what happens under a consumption tax: it excludes all investment returns from income, and denies all deductions for interest.

## 2. *Proposals for Legislative Change*

In every Congress we see proposals for reforming the tax treatment of education expenditures. We already have an interest exclusion for Education Savings Bonds.<sup>153</sup> One type of proposal would restore the interest deduction for education loans.<sup>154</sup> Another type of

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living expenses) at nearly all schools. *See also* TALLEY & LYKE, *supra* note 147, at n.17 ("From the standpoint of need-based student aid, the deductibility of home equity loans used for educational expenses is difficult to justify."). Incidentally, the likely borrower (that is, the homeowner) is the student's *parents*, who get more bang out of the interest deduction both by being more likely to itemize deductions in the first place and by being in a higher tax bracket.

152. *Compare* LANA CHANDLER & MICHAEL D. BOGGS, THE STUDENT LOAN HANDBOOK 38 (1990) (about 50% of home equity loans go to parents financing their children's education) *with* GENERAL ACCOUNTING OFFICE, PUB. NO. GAO/HRD-93-IR, NONFEDERAL STUDENT LOANS, at 3, 7 (1992) (banking industry studies conservatively estimate that 10% of home equity loans are taken out for education, totaling about \$2.4 billion in 1991, and, further, the average annual income of home equity borrowers exceeds \$30,000).

153. I.R.C. § 135, added by the Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, 102 Stat. 3342 (1988), excludes from income the proceeds of U.S. savings bonds up to the amount of higher education tuition and fees paid that year for the taxpayer, the taxpayer's spouse, or a dependent; the exclusion phases out for higher income taxpayers. *See also* H.R. 11, 102d Cong., 2d Sess. (vetoed Nov. 5, 1992) (would have eliminated the dependency and other requirements, and removed the income phaseout).

154. *See, e.g.*, H.R. 1667, 103d Cong., 1st Sess. (1993) (allowing either a deduction or a nonrefundable credit (for nonitemizers) for interest paid on qualified education loans; the credit would generally equal 15% of the interest, up to a maximum annual credit of \$300); *see also* STAFF OF THE JOINT COMM. ON TAXATION, DESCRIPTION OF MISCELLANEOUS TAX PROPOSALS SCHEDULED FOR HEARINGS BEFORE THE SUBCOMMITTEE ON SELECT REVENUE MEASURES OF THE HOUSE WAYS AND MEANS COMMITTEE (1993).

Now that Congress has adopted President Clinton's student loan reforms (discussed in part II.C), it would have to specify, should it restore an interest deduction for student loans, how borrowers would determine what portion of income-contingent payments represented "interest." Recently proposed and then withdrawn Treasury regulations setting forth the tax results of "contingent interest" would, in the case of small issues, have allowed borrowers to treat all payments made as first reducing principal and payments thereafter as interest. *Cf.* Rev. Rul. 72-2, 1972-1 C.B. 19, discussed *infra* note 206. Any scheme should try to deal with a current low-income graduate who can be expected to earn high income later in the payment term.

proposal would move towards a consumption base concept and allow investment income to accumulate free of tax in an education account much like an individual retirement account.<sup>155</sup> As already shown, targeted income exclusions just create more distortions between education and other "investments." I am not aware of any proposals that would simply allow a cost recovery deduction for education expenses,<sup>156</sup> although to the extent that student loans are forgiven (for national service under President Clinton's proposal or by the schools themselves<sup>157</sup>) or that grants or scholarships cover the cost and no income results to the student, it amounts to the same thing.<sup>158</sup>

155. See, e.g., H.R. 1311, 103d Cong., 1st Sess. (1993); Sen. Amend. 487 to H.R. 2118, § 341 (failing June 22, 1993); Higher Education Accumulation Program Act of 1994, H.R. 3897, 103d Cong., 2d Sess. (proposed February 24, 1994).

156. Consider the following answer then President-elect Clinton gave to an adult student who asked if his administration would consider making college education tax deductible:

Well, if you send yourself to college, then . . . whether that would be a real incentive would really depend, as a practical matter, on how much income a person has. That is, if it was just a tax deduction and you were already in the 15 percent income tax bracket, which most Americans would be in [who] would be going through college . . . , if you spend \$2,000 on college, you could deduct that from your income.

So, if you had a — let's say you had a \$20,000 income, that would give you an \$18,000 income. . . . Would you be better off doing that, or having a dramatically expanded loan program which you could work off later or pay off over 10 to 20 years as a small percentage of your income? How many would prefer the tax deduction? (Applause.)

How many prefer the expanded loans? (Applause.)

Maybe, there's no reason we would not be able to do — make it an either or.

We might be able to give people an elective. But, I've never thought about it before, and I can't say I'll be for it until I figure it out.

*Address by President-Elect Bill Clinton at Wilbur Wright Community College, Chicago, Illinois, supra note 26.* What President Clinton does not realize is that under a nondistorting taxing scheme, both the interest on the debt and the outlay for education would, at some point, be deductible. What he does realize, though, is that either of these changes would be quite expensive. Further, like any tax deduction in our progressive system (including those for conventional business assets), these changes appear to "benefit" the middle and upper-class more than those in lower income brackets.

157. If a student loan borrower undertakes certain employment (such as providing medical services in a rural area), Internal Revenue Code section 108(f) allows the borrower to exclude from income the amount of student loans whose repayment is forgiven by the federal or a state government. See also 139 CONG. REC. S5646, S5647-50 (1993) (to extend section 108(f) relief to student loans forgiven by an educational institution or other nonprofit organization in return for taking public interest or community benefit work). See generally J. Timothy Phillips & Timothy G. Hatfield, *Uncle Sam Gets the Goldmine — Students Get the Shaft: Federal Tax Treatment of Student Loan Indebtedness*, 15 SETON HALL LEGIS. J. 249 (1991).

158. We must end our discussion of tax subsidies with a cautionary tale: do not act before Congress grants the subsidy. The sad case of the Michigan Education Trust serves as a testament to parental desperation in the face of ever-growing tuition projections,

## PART II: GOVERNMENT AS CREDIT PROVIDER

### A. The Function of Debt

We are a nation obsessed with debt. The federal debt exploded as *the* issue of the 1992 presidential campaign,<sup>159</sup> and President Clinton has made reducing the *growth* of the debt (although not the absolute amount)<sup>160</sup> his domestic priority. (His student loan reform package

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state governments' will to please its (middle-class) constituents at the expense of the federal government, and investment advisors' never-ending search for tax-subsidized savings vehicles. See generally Jeffrey S. Lehman, *Social Irresponsibility, Actuarial Assumptions, and Wealth Redistribution: Lessons About Public Policy from a Prepaid Tuition Program*, 88 MICH. L. REV. 1035 (1990).

The Michigan Education Trust ("MET"), a state-created corporation, entered into contracts with parents to supply four years of education at a Michigan institution of higher education when the parents' child enrolls in the future, in exchange for a payment up front of an actuarially determined amount. *Michigan v. United States*, 802 F. Supp. 120 (W.D. Mich. 1992). However, Michigan did not stand behind the payoff. Therefore, if tuition prices increased faster than MET's investment earnings, MET would be unable to deliver on the contracts. (The governor, however, pressured state schools to hold down their tuitions to the increases assumed by the trust's actuaries. Lehman, *supra*, at 1114.) MET agreed to pay a refund only if the child dies, is denied admission to a Michigan public institution, has reached 18 and certifies that she will not attend college, or if the program becomes actuarially unsound.

The Internal Revenue Service ruled that neither the parents nor the child have current income, but ruled adversely on every other tax issue. See Priv. Ltr. Rul. 88-25-027 (Mar. 29, 1988); see also Ellin Rosenthal, *Tax Implications of Michigan Tuition Prepayment Program Remain Unsettled*, 39 TAX NOTES 676 (1988). First, while the contract price paid by the parent qualifies as a gift excluded from the child's income, the child will recognize income when she later enrolls to the extent that the fair market value of the educational services (or refund) exceeds her carryover basis in the contract. Second, the trust must currently pay tax on its income, because under the facts it is not an integral part of the state (nor does the income accrue to the state in the performance of an essential governmental function under Internal Revenue Code section 115). Third, the purchase price paid by the parent constitutes a completed gift qualifying for neither the \$10,000 annual gift tax exclusion (because it is a gift of a future interest) nor for the unlimited gift tax exclusion for tuition payments (because it is made to the trust and not to the educational institution). (Recall discussion in part I.C.2.) The district court upheld all of these rulings, as well as the Internal Revenue Service's rejection of MET's separate application exempt status as a charity. *Michigan*, 802 F. Supp. at 123 (describing MET as a corporation for tax purposes).

In just four years, MET had paid taxes of about \$29 million. Karen Pierog, *Michigan Will Appeal Decision Finding that Prepaid Tuition Is Not Tax Exempt*, BOND BUYER, Aug. 20, 1992, at 2, available in LEXIS, NEWS Library, BNDBYR File. Shortly after the court decision, however, MET ceased marketing the contracts, thus freezing the pool at 55,000 contracts. *Id.*; Victor A. Babal et al., *Dunce Cap for Trust Fund*, CITY & STATE, May 4, 1992, at 5, available in LEXIS, NEWS Library, CTY&ST File. By spring 1993, MET's surplus had dropped from \$23.5 million to \$2 million, "raising questions about the viability of the controversial program." *Pre-Paid Tuition: Mich. Plan's Surplus Drops Drastically*, DAILY REP. CARD, March 11, 1993, available in LEXIS, NEWS Library, RPTCRD File. While a few other states adopted similar plans, Florida maintains that, unlike Michigan, its prepaid tuition contracts are backed up by the full faith and credit of the state, and so its trust's investment income cannot be taxed by the federal government. See Pierog, *supra*.

159. This is despite the Treasury Department's Office of Domestic Finance having for years called its softball team "Megadebt."

160. Politicians like to use the confusing terminology to suit their goals. When

passed in Hill committees that had no better way to meet their assigned deficit-reduction targets.<sup>161</sup>) At the individual level, the public views credit cards as wicked temptation, and a credit-cardless life as the first step toward sainthood. There is nothing, however, intrinsically evil about debt. To say that the government spends fifteen percent of its budget on interest each year sounds shockingly wasteful.<sup>162</sup> But how much of our annual household budget do we devote to mortgage interest alone?

What's the difference between good debt and bad debt? Economically, borrowing is just a question of weighing risks and rewards. Thus, it can make sense to borrow to buy a house, to pay college tuition, to sell short, or to finance a war. The current national debt is a problem only if it is being used to finance current consumption at the expense of the standard of living of the next generation.<sup>163</sup>

Unfortunately, an educational expense is of the type most difficult to borrow for — "A student loan is a perfect example of the type of loan that private lenders find costly: the loan is for a small amount, there is no marketable asset that can provide collateral, and the highly mobile borrower generally has no credit history."<sup>164</sup> If the government did nothing more than facilitate access to credit, at fair market rates (as best these can be set where no market otherwise exists), it would perform a valuable function to a cash-strapped family.

Americans currently exhibit a range of ambivalent and inefficient behavior patterns when it comes to borrowing for college. Distressingly, those at the low end of the income range are quite reluctant to

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describing the enormity of the problem, they refer to the debt, but when they want to seem to be doing something about it they switch to the (annual) deficit.

161. See, e.g., James Jeffords, *Report Card on Clinton's First 100 Days*, ROLL CALL, Apr. 19, 1993 available in LEXIS, NEWS Library, ROLLCL File (the size of the committee's target for cuts in nondiscretionary spending, meant, "[a]s Willie Sutton might have noted, . . . student loans, because that's where the money is in the Labor Committee").

162. See, e.g., *Address by President-Elect Bill Clinton at Wilbur Wright Community College, Chicago, Illinois*, *supra* note 26 ("[W]e are spending too much of our money on yesterday, because our government debt is too high . . . . [T]he interest on the debt is over 15 cents on the tax dollar now every year. It will soon be more than we spend on national defense — just paying the interest on yesterday's debt.").

163. See discussion of the federal deficit in part I.B.

164. BARRY P. BOSWORTH ET AL., *THE ECONOMICS OF FEDERAL CREDIT PROGRAMS* 130-31 (1987).

borrow,<sup>165</sup> even though this group would likely find the greatest percentage improvement in lifetime earnings from a college education.<sup>166</sup> By contrast, the better off are those who are already quite comfortable with borrowing, and, moreover, they benefit more from tax-deductible interest under the current loophole, discussed above, for home equity loans used to finance education (or any other consumer expenditure). Finally, the most available form of unsecured consumer credit — credit cards — has even been used to finance higher education. This is crazy: credit cards carry the highest interest rates around, and so are best employed tiding one over for short periods, not for the many years over which a college education provides benefits.<sup>167</sup>

### B. The Guaranteed Student Loan Program

Under the long-standing federal student loan program, the private sector has provided the funds for higher education loans.<sup>168</sup> Aside from imposing borrowing and eligibility limits, the federal government guarantees the student's repayment obligation in the event of default.<sup>169</sup> About \$15 billion in new loans were expected to be issued

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165. See, e.g., MORTENSON, *supra* note 41, at ii ("For any purpose, the poor are less likely than the financially better off to be willing to assume debt."); McPherson & Skinner, *supra* note 56, at 34 n.16 ("We say 'in principle' loans could handle the load because there is evidence that in fact students from disadvantaged backgrounds are reluctant to borrow heavily for education, partly because their families have little experience with long-term credit (and the experience is often negative)."); see also, e.g., Jerry Thomas, *Black Colleges' Cash Woes Keep Out Cream of the Crop*, CHI. TRIB., Nov. 9, 1992, at 1 (for one teenager "who wants to go into business and aspires to become a U.S. Supreme Court justice, attending a black college is a closed chapter for now. She declined to take out a student loan, fearing it would stall her efforts to earn her master's and then a law degree.").

166. Cf. JOHNSTONE, *supra* note 45, at 150-51 n.1 ("There is absolutely no validity to the frequent charge that income contingent lending *per se* constitutes a threat to students from low-income families. These students, in fact, are by far the heaviest borrowers now and stand to gain the most from more manageable borrowing opportunities.").

167. GERALD KREFETZ, *HOW TO PAY FOR YOUR CHILDREN'S COLLEGE EDUCATION* 101 (1988).

168. Higher Education Act of 1965, Pub. L. No. 89-329, 79 Stat. 1219 (1965), (Title IV, part B — Federal Family Education Loan program (formerly the Guaranteed Student Loan Program)) (codified as amended at 20 U.S.C.A. §§ 1071 to 1087-2 (West 1990 & Supp. 1994)); see also 34 C.F.R. § 659. Since its inception, the Federal Family Education Loan program has supported over \$130 billion in loans. H.R. REP. NO. 156, 103d Cong., 1st Sess., pt. 2 (1993). The federal government also indirectly subsidizes states that issue tax-exempt education bonds, via the federal exemption of interest paid to bondholders. I.R.C. § 103(a) (interest on state and local bonds); I.R.C. § 144(b) (qualified student loan bonds). Congress's General Accounting Office found that nonfederal lenders (state or nonprofit programs) imposed stricter requirements than do the federally guaranteed loan rules: the programs generally require the applicant to demonstrate credit worthiness, and often refuse to lend to those attending proprietary institutions, in an attempt to minimize their creditor risks. GENERAL ACCOUNTING OFFICE, *supra* note 152.

169. 20 U.S.C.A. §§ 1087, 1091 (West Supp. 1994).

in 1993, exploding to \$18 billion in 1994.<sup>170</sup> Defaults cost the government billions of dollars a year, although studies show that the size of the loan is less often the cause than the fact that the student dropped out of school, thus forfeiting the higher income that usually follows a college degree.<sup>171</sup>

Several distinct loan programs exist, with varying levels of federal subsidy.<sup>172</sup> For example, under the Stafford loan program, available

170. *House Vote Raises Student Loan Hopes*, FDIC WATCH, July 5, 1993, available in LEXIS, NEWS Library, ABBB File. See generally U.S. BUREAU OF THE CENSUS, STATISTICAL ABSTRACT OF THE UNITED STATES: 1992 tbl. no. 267, at 168 (112th ed. 1992).

171. The Office of Management and Budget estimates the federal government will pay \$2.5 billion to cover unpaid loans in fiscal year 1993, down from \$2.7 billion in fiscal year 1992 and \$3.6 billion the previous year. Defaults have fallen because in 1989 Congress halted lending to schools with default rates of 30% or higher. *U.S. Student Loan Default Rate Drops in FY 1991*, July 19, 1993, available in LEXIS, NEWS Library, REUFIN File. See generally Laura G. Knapp & Terry G. Seaks, *An Analysis of the Probability of Default on Federally Guaranteed Student Loans*, 74 REV. ECON. & STATS. 404 (Feb. 1992). See also Joseph J. Eglin, *Untangling Student Loans*, Soc'y, Jan.-Feb. 1993, at 52, 54 (The "GAO has recommended that the six-month grace period on repayment . . . be eliminated for those who do not complete their programs. This would encourage borrowers to continue their studies and, in turn, might help reduce defaults."). The law does not require lenders to make credit checks of applicants under the age of twenty-one. 20 U.S.C.A. § 1077(a)(2) (West Supp. 1994). However, graduate students do not appear to be a great credit risk. See Laurence W. O'Toole, President, New England Educ. Loan Mktg. Corp., National Student Loan Trust: A Proposal for Implementation 2 (Feb. 1992) (on file with author) ("Graduate students default at a rate less than ½ of 1%."); see also GENERAL ACCOUNTING OFFICE, PUB. NO. GAO/HRD-99-138FS, PARENT AND SUPPLEMENTAL STUDENT LOANS: VOLUME AND DEFAULT TRENDS FOR FISCAL YEARS 1989 TO 1991, at 6 (1992) ("Proprietary school borrowers accounted for \$1.1 billion (about 83 percent)" of defaults in unsubsidized loans to students. "Freshmen borrowers at these schools were responsible for \$1 billion of these defaults.").

172. The programs cost the federal government \$4.6 billion in fiscal year 1991, mostly "to cover administrative costs, subsidies, and payoffs of defaulted loans." Eglin, *supra* note 171, at 53. For detailed statistics of the various federal programs, and their cost to the federal government, see H.R. REP. NO. 156, *supra* note 168.

Constant renaming of the various loan programs can be confusing; readers, depending on their ages, might recognize some of the following programs. Most subsidized are the low-interest Perkins Loans (formerly National Defense or National Direct Student Loans), under which institutions of higher education make direct loans out of primarily federally-seeded revolving funds. 20 U.S.C.A. §§ 1087aa-1087hh (West 1990 & Supp. 1994); 34 C.F.R. § 674 (1993). Carrying in-school interest subsidies and somewhat subsidized interest rates are the need-based Stafford Loans (formerly Guaranteed Student Loans). 20 U.S.C.A. §§ 1077-1078 (West 1990 & Supp. 1994). The government's costs for both of these programs depend upon the relationship between the current rate at which the Treasury can borrow and the statutory interest rates (for example, Stafford loans currently charge no interest while the student is in school, 8% during the first four years of repayment, and 10% in the remaining six years). See, e.g., Joseph M. Cronin & Sylvia Q. Simmons, *Myths and Realities of Student Indebtedness*, in STUDENT LOANS: RISKS AND REALITIES, *supra* note 11, at 20; GENERAL ACCOUNTING OFFICE, PUB. NO. GAO/HRD-92-113, GUARANTEED STUDENT LOANS: ELIMINATING INTEREST RATE

to those from needy families, the federal government pays the student's entire interest obligations while the student is in school and also makes "special allowance payments" to lenders throughout the life of the loan "to raise their interest revenue to competitive levels."<sup>173</sup> Those ineligible for subsidized loans (or parental borrowers) must pay market interest rates, even while the student is in school, although these loans still carry the federal guarantee against default.<sup>174</sup>

Current aid-eligibility rules fail to distinguish between temporary financial need and lifetime financial need.<sup>175</sup> Moreover, the rules provide a perverse incentive for parents *not* to save prior to their children's attending college in order to appear financially needy.<sup>176</sup>

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FLOORS COULD GENERATE SUBSTANTIAL SAVINGS (1992). Carrying no in-school subsidy and a generally higher interest rate (the rates are variable, and so can actually be lower than the fixed Stafford rates) are the Parent Loans for Undergraduate Students (PLUS), 20 U.S.C.A. § 1078-2 (West Supp. 1994); the Unsubsidized Stafford Loans for Middle Income Borrowers, for undergraduates, *id.* § 1078-8 (West Supp. 1994); the Supplemental Loans for Students (SLS), for independent and graduate students (previously the Jeffords Loan Program or the Auxiliary Loan to Students (unfortunately, ALAS!)), *id.* § 1078-1 (West 1990 & Supp. 1994) (repealed, effective July 1, 1994, by OBRA 1993, *supra* note 8, § 12048(b)); and a consolidated loan program, *id.* § 1078-3 (West 1990 & Supp. 1994). The Higher Education Amendments of 1992 adopted the term "Federal Family Education Loan Program" to refer collectively to Stafford Loans, Unsubsidized Stafford Loans, SLS, PLUS, and consolidated loan programs. Pub. L. No. 102-325, Title IV, § 411(a)(1), 106 Stat. 448, 510 (1992); *see also* 34 C.F.R. pt. 682 (1993).

173. GENERAL ACCOUNTING OFFICE, PUB. NO. GAO/HRD. 93-27, STUDENT LOANS: DIRECT LOANS COULD SAVE BILLIONS IN FIRST 5 YEARS WITH PROPER IMPLEMENTATION 2 (1992). *See generally* 20 U.S.C.A. § 1087-1 (West 1990 & Supp. 1994).

174. Even the so-called "unsubsidized" loans can also enjoy a special allowance payment, once the student is out of school, because the interest rate for both Stafford and unsubsidized Stafford loans is capped at 8.25% (previously 9% for subsidized loans, 11% for independent-student unsubsidized loans, and 10% for PLUS loans). OBRA 1993, *supra* note 8, § 455(b). The formula for setting the interest rate on Stafford loans has been floating at the 91-day Treasury bill rate plus 3.1% of the loan — meaning that under current low rates, 1993 interest is 6.22%. *See, e.g.,* Jane Bryant Quinn, *Changes in Student Loans Will Aid the College-Bound*, WASH. POST, Aug. 22, 1993, at H3. Beginning July, 1995, the formula for subsidized loans drops to 2.5% over the 91-day T-bill rate while the student is in school; and, once the loan is in repayment status (and for unsubsidized loans), beginning July, 1998, to 1% above the bond equivalent rate on a security with a comparable maturity (2.1% above the bond equivalent rate for PLUS loans). OBRA 1993, *supra* note 8, § 455(b); OBRA Conference Report, *supra* note 32, at 445-46.

175. Rules focus too narrowly on the current financial resources of the family. *See infra* part II.E; 20 U.S.C.A. §§ 1087kk-1087vv (West Supp. 1994). The snapshot approach to financial need "cannot distinguish between the frugal poor and the spendthrift. It cannot distinguish between improvidence and financial hardship." McPherson & Skinner, *supra* note 56, at 36 n.17 (quoting from a financial aid manual). Many parents, whether out of lack of foresight or genuine high costs in raising their children, could not finance their children's college expenses out of current income. *See id.* at 29 ("Surveys indicate that few parents even begin to think about saving for their children's college education until the children are well along in high school."); KREFETZ, *supra* note 167, at 100 ("Parents generally fall into two categories; those who have prepared to pay college bills from the day their children were born, and the rest of us.").

176. *See* McPherson & Skinner, *supra* note 56; Aaron S. Edlin, *Is College Aid*



When the federal government first got into the student loan business in 1958, it did not subsidize the interest rate (although the government did pay interest while the student was in school).<sup>177</sup> Several years later, then-Senator Lyndon Johnson's initial student loan proposal (enacted in much different form in 1965 after he became president) provided that the program would be self-supporting (and hence was open to all regardless of financial need).<sup>178</sup> The Higher Education Act of 1965 offered only subsidized loans, necessitating a needs test. Congress briefly, and disastrously, removed the needs test in the late 1970s, inducing massive interest-rate arbitrage by high-income parents who could not pass up the subsidized rates.<sup>179</sup> The recent shift towards universal student loans "has been part of a larger transformation . . . from a program intended mainly to ease the cash-flow problems of non-needy families to a major source of funds for low-income students attempting to pay for college."<sup>180</sup> While this is still true, we have to some degree returned to our roots with the relatively new unsubsidized loan programs for higher-income families.

### C. Clinton's Student Loan Program

On March 1, 1993, President Clinton announced the parameters of his higher education student loan proposal.<sup>181</sup> Invoking the spirits of the Civilian Conservation Corps, the GI Bill, and the Peace Corps, Clinton declared that "[w]hen people give something of invaluable merit to their country, they ought to be rewarded with the opportunity to further their education."<sup>182</sup> He also decried the current structure, under which, "when students borrow money for an education, the repayment plan they make is based largely on how much they have to repay without regard to what the jobs they take

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*Equitable and Efficient?*, 7 J. ECON. PERSP. 143 (1993).

177. Morse, *supra* note 17, at 4. Nor did the contemporaneous state student loan guarantee programs (in Massachusetts and New York) subsidize the rate (as distinct from the guarantee feature). *Id.* at 5.

178. *Id.* at 12-13.

179. The generous provisions of the Middle Income Student Assistance Act of 1978, Pub. L. No. 95-566, 92 Stat. 2402 (1978), were repealed by the Postsecondary Student Assistance Amendments of 1981, Pub. L. No. 97-35, §§ 532-533, 95 Stat. 450 (1981).

180. Hansen, *supra* note 6, at 17.

181. President Clinton, Remarks at Rutgers University, Rutgers Athletic Center, Piscataway, New Jersey (Mar. 1, 1993), available in LEXIS, NEWS Library, FEDNEW File [hereinafter President Clinton, Remarks at Rutgers University].

182. *Id.*

themselves pay.”<sup>183</sup> He believed this structure to be “a powerful incentive, therefore, for young college graduates to do just the reverse of what we might want them to do, to take a job that pays more, even if it is less rewarding, because that is the job that will make the repayment of the loans possible.”<sup>184</sup> Clinton subsequently sent up to Capitol Hill two separate bills, which were introduced in Congress as the National Service Trust Act of 1993 and the Student Loan Reform Act of 1993; the student loan reform proposal was folded into the Omnibus Budget Reconciliation Act of 1993, and the national service proposal separately passed as a free-standing bill.<sup>185</sup> While the Administration fell short of its goal of complete direct lending,<sup>186</sup> the winners will still, at least in significant part, be the student borrowers.<sup>187</sup>

To remedy these financial pressures on new graduates, President Clinton proposed two novel methods of loan repayment. His national service legislation permits young people, for one or two years, “to work off outstanding loans or to build up credits for future education and training opportunities.”<sup>188</sup> His direct lending legislation permits

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183. *Id.*

184. *Id.* He continued, “It is also, unfortunately, a powerful incentive for some not to make their payments at all, which is unforgivable.” *Id.*

185. Congress passed the Student Loan Reform Act as Title IV of OBRA 1993, *supra* note 8, and separately passed the National and Community Service Trust Act of 1993, Pub. L. No. 103-82, 107 Stat. 785 (1993).

186. See *infra* part II.E.1 for a discussion of federal direct lending versus a federal guarantee of private loans.

187. See OBRA Conference Report, *supra* note 32, at 445-46 (statement of the Managers describing lower interest rates and lower caps); see also, e.g., Adam Clymer, *New U.S. Program of Student Loans Clears Key Panel*, N.Y. TIMES, June 11, 1993, at A1 (“The most immediate saving would be to students, who now pay fees of as much as \$80 for every \$1,000 borrowed. Under the bill, those fees would be cut in half, whether the loan was coming from the Government or from a bank.”).

188. President Clinton, Remarks at Rutgers University, *supra* note 181. This national-service aspect of Clinton’s proposal has, understandably, attracted the lion’s share of public and media attention. After arm-twisting by the military — which has “found that money for school is the most common reason cited for joining the military” — the White House reduced the maximum annual amount a student could earn towards college expenses from \$6,500 to \$5,000. *National Service Plan Shouldn’t Hurt Military Recruiting*, *Says Montgomery*, Apr. 30, 1993, available in LEXIS, NEWS Library, PRNEWS File (“Parity between these two programs would have denigrated the service and sacrifice of those who wear the uniform.”). Public sector unions fear displacement by underpaid “volunteers.” See, e.g., Aaron Bernstein, *New Schools of Thought on Paying for College*, BUS. WK., Oct. 12, 1992, at 58; see also, e.g., Bruce Chapman, *Pass National Service, Cripple Charity*, WALL. ST. J., May 24, 1993, at A10, A10 (“[I]f your charity, like the great majority, is not chosen [to participate in the national service program], your cause will find itself trying to compete with the federal treasury.”); Gary S. Becker, *Clinton’s Student-Loan Plan Deserves an ‘F’*, BUS. WK., June 14, 1993, at 18, 18 (“The President’s plan sends a dubious message to young people. . . . that it is more beneficial to spend time helping to build housing for the homeless . . . than to contribute to the productivity of the U.S. economy by becoming better engineers, computer programmers, architects, etc.”); see also D. Bruce Johnstone, *A Pipe-Dream Peace Corps*, NEWSDAY, Mar. 5, 1993, at 46, 46. Johnstone writes:

borrowers to "pay [college loans] back as a small percentage of their own income over time."<sup>189</sup> A graduate may elect income-contingent repayment from a variety of proposed repayment methods;<sup>190</sup> additionally, upon default, a loan in repayment under another mechanism converts automatically into an income-contingent loan.<sup>191</sup> However, Clinton's proposal retained, for each type of loan, "the terms, conditions, and benefits of its corresponding guaranteed loan";<sup>192</sup> thus, those currently eligible for interest rate subsidies would continue to qualify for them.

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National service is actually a very costly way to get a relatively small number of young people in and out of college — considerably more costly to the taxpayer than a fully funded grant program for the same number of students, and much more costly to the taxpayer than an expanded federal loan program. If the Clinton program makes sense — and it may — it must be on the basis of the benefits of national service, not because it expands access to higher education.

*Id.*; see also Jennifer Babson, *Goodling Amendment to National Service Plan Fails on Floor*, July 21, 1993, available in LEXIS, NEWS Library, SNS File. The bill as introduced provided that the amount of the "national service award" would not be considered income for tax purposes, although the "living allowance" would not be excluded from gross income. See 139 CONG. REC. S5594 (1993) (proposed H.R. 2010, 103d Cong., 1st Sess. § 148(f) (1993): loan repayment amount); 139 CONG. REC. S5594 (proposed H.R. 2010, 103d Cong., 1st Sess. § 140(a)(5) (1993): living allowance). Perhaps this was designed to parallel the tax treatment of scholarships, which are tax-free only to the extent they cover tuition and related expenses, but not living costs. I.R.C. § 117. See generally Crane, *supra* note 139. In any event, these proposals did not survive in conference. See National and Community Service Trust Act of 1993, Pub. L. No. 103-82, §§ 101(b), 102(a), 107 Stat. 785, 788 (1993) (creating 42 U.S.C.A. § 12501 (West Supp. 1994), and adding § 148 to subtitle D of title I of the National and Community Service Act of 1990 (42 U.S.C.A. § 12571 (West Supp. 1994))).

189. 139 CONG. REC. S5627 (daily ed. May 6, 1993).

190. *Id.* For those saddled with tens of thousands of dollars in debts, one lesser-publicized feature of Clinton's student loan proposal would offer extended periods of time in which to repay even a fixed (i.e., non-income contingent) loan. Cf. McPherson & Skinner, *supra* note 56, at 29 ("[T]he standard loans available to college students must be paid back within 10 years after they leave school — even though the returns on the investment in education are spread over the rest of their lives.").

191. 139 CONG. REC. S5627 (daily ed. May 6, 1993).

192. *Id.* at S5630.

#### D. Who Should Pay for the Insurance Features of an Income-Contingent Loan?

Income-contingent student loans are not new.<sup>193</sup> Milton Friedman first proposed them over thirty years ago,<sup>194</sup> and various proposals have surfaced over the years. Another economics Nobel Prize winner, James Tobin, helped Yale University design a tuition postponement plan with an income-contingent repayment feature, which ran in the 1970s.<sup>195</sup> With varying levels of subsidies, several other countries employ income-contingent insurance features to protect their graduates from the risks of a poor job market.<sup>196</sup> Indeed, Clinton's

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193. For a thorough description of early income contingent plans, see JOHNSTONE, *supra* note 45. Surprisingly, Professor Johnstone, who is now chancellor of the State University of New York and current chairman of the College Board, recently termed income-contingent loans "old, overrated gimmicks." Johnstone, *supra* note 188, at 46.

194. FRIEDMAN, *supra* note 125, at 104-07. Friedman's proposal, as well as the later, even more theoretical, proposal offered by economist William Vickrey, sought to isolate the "value added" by a college education. If, for example, an unambitious kid with few prospects achieves a high-paying job after college, a large amount of his future salary should be claimed to repay the amount loaned. By contrast, a bright and accomplished kid who merely fulfills her adolescent promise after college would owe little. JOHNSTONE, *supra* note 45, at 69-70 (discussing William S. Vickrey, *A Proposal for Student Loans*, in *ECONOMICS OF HIGHER EDUCATION* 268-80 (Selma Mushkin ed., 1962)). Such a proposal has obvious equity limitations in addition to valuation limitations. The only way to treat these two students equivalently would be to tax the second one on the increased "endowment" she inherited or developed prior to entering college. Cf. Warren, *supra* note 111, at 1113-14 ("[T]he individual who has an innate ability to play basketball or to pick successful television shows has at some point in his life acquired significant human capital, which is an increment in wealth that should in theory be subject to taxation under the Haig-Simons concept.").

195. See also discussion *infra* part II.E.2.

196. Australia only recently imposed any tuition charges on those attending colleges, making income-contingent loans available to cushion the burden. See Memorandum from Bob Shireman, Legislative Assistant, to Senator Paul Simon (Mar. 6, 1993) (on file with author). Nor do English schools currently charge tuition, and their government even provides housing allowances, but the amount of these grants was frozen in 1990 and replaced with student loans charging interest set at the rate of inflation. Neasa MacErlan, *Spotting the Difference in the Big Banks' Student Packages*, INDEPENDENT, July 17, 1993, at 21 (interest rate is scheduled to fall to 1.2% from 3.9% in 1992-93 and 5.8% the previous year); Jill Papworth, *The Black Cloud that Hangs Over Students in the Red*, GUARDIAN, July 3, 1993, at 29 (government-provided housing allowances for students were frozen in 1990, replaced with low-cost student loans). In its report *Learning to Succeed*, Britain's National Commission on Education recommended in November, 1993, that the U.K. should require students to shoulder more of the cost of their higher education through income-contingent student loans, repayable through the tax system; ironically, Britain is subject to the same budgetary accounting rules that used to apply to Congress (see BOSWORTH, ET AL., *supra* note 164), and so the Commission recommended that the loans be funded by private parties with a government guarantee (citing the U.S. model!). See Liz Heron, *Education: The High Cost of Learning*, INDEPENDENT, Dec. 9, 1993, at 30; Christopher Johnson, *Personal Viewpoint: Lesson in Maximizing Human Capital*, FIN. TIMES, Feb. 23, 1994, at 21. A study recently recommended that Canadian students should repay loans in proportion to post-graduate income, with Revenue Canada serving as collector. EDWIN G. WEST, *ENDING THE SQUEEZE ON UNIVERSITIES* (1993) (basing the proposal on New Zealand's 1992 model,

proposal contained many of the features of bills introduced the previous year by Senators Simon, Bradley, Durenberger, and Kennedy, and by Congressmen Petri and Miller.<sup>197</sup>

A lender can adopt any one of a myriad of income-contingent loan models.<sup>198</sup> The models raise issues of design, implementation, and acceptance not found in conventional loans. This section focuses on the "insurance" features of these loans. There are two basic types of income-contingent loans: those that are "mutualized" and those that enjoy an external subsidy.<sup>199</sup>

A mutualized plan breaks even, so that in the aggregate each pool of borrowers returns the principal borrowed plus interest (and costs). Each borrower, however, pays only a stated percentage of his or her income, with the winners in the education pay-off subsidizing the losers.<sup>200</sup> In a sense, while the lender still acts as a creditor, the borrowers in the group act almost as partners, taking an equity stake in each others' economic future until the cohort repays the obligation. There is usually a cap, however, on how much any successful graduate is required to pay, either as a multiple of principal borrowed or as effective interest rate paid,<sup>201</sup> and every borrower is commonly required to pay at least the amount of principal borrowed, to avoid

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which he views as superior to Australia's 1989 oversubsidized plan). *See generally* Johnstone, *supra* note 11, at 89 (studying England, France, West Germany, Sweden, and Romania). Recently, Germany's Education Minister was forced to resign after students rioted in protest of the government's decision to freeze interest-free loans to those from low-income families. *See German Education Minister Resigns*, Feb. 3, 1994, available in LEXIS, NEWS Library, XINHUA File, Item No. 0203062.

197. *See The Income-Dependent Education Assistance Act: Hearing on H.R. 2336 Before the Subcomm. on Postsecondary Education of the House Comm. on Education and Labor*, 102d Cong., 2d Sess. (1992) [hereinafter *Hearing on H.R. 2336*]; *The Self-Reliance Scholarship Act: Hearings on H.R. 3050 Before the Subcomm. on Postsecondary Education of the House Comm. on Education and Labor*, 102d Cong., 2d Sess. (1992); *Federal Direct Student Loans: Hearing on S. 2255 Before the Senate Comm. on Labor and Human Resources*, 102d Cong., 2d Sess. (1992) [hereinafter *Hearing on S. 2255*]. In the July 1992 amendments to the Higher Education Act, Congress approved a small pilot program of direct lending, with an income-contingent repayment feature, to begin in 1994 (*see President Signs Bill Reauthorizing the Higher Education Amendments Act of 1965*, BNA BANKING REP., July 27, 1992, at 127, available in LEXIS, NEWS Library, BNABNK File); obviously it is superseded by the new legislation, also scheduled to begin in 1994 (*see infra* note 223, discussing final regulations for the pilot program).

198. *See* JOHNSTONE, *supra* note 45, for an excellent analysis of the policy alternatives and financial constraints.

199. *Id.* at 109-14.

200. *See id.* at 154-56 ("If incomes should fail to rise as expected, however, repayments would fail to cover cost even with no defaults.").

201. *See* Marc Nerlove, *Some Problems in the Use of Income-Contingent Loans for the Finance of Higher Education*, 83 J. POL. ECON. 157 (1975).

the issue of income from the discharge of indebtedness. By contrast, in an externally subsidized program, each borrower still pays a percentage of income but only until that borrower has repaid what he or she borrowed with interest; any shortfall in repayments made by the lower-earning members of the pool is made up by an external source (usually the educational institution or the government). If desired, a plan could, by its choice of interest rate and "exit" formula, combine some mutualized and some subsidized features.

Income-contingent loans require repayment only as measured by "adjusted gross income" as defined by the tax rules — and adjusted gross income, at best, includes only money and money's worth.<sup>202</sup> Those whose rewards come in the form of psychic income will, if the loan terminates before all interest has been paid, fare better than those paid in monetary terms. Whether this is a weakness or a strength evidently depends on what you think is more "valuable" to society. One scholar wonders, "More important than a possible but improbable labor market effect may be the equity of such discrimination: why should some be forgiven portions of their debts simply because they freely chose to be ministers rather than corporate lawyers?"<sup>203</sup> Far from troubling President Clinton, this possibility served as the foundation of his proposal: "A student torn between pursuing a career in teaching or corporate law, for example, will be able to make a career choice based on what he or she wants to do, not how much he or she can earn to pay off college debt."<sup>204</sup> (Another possible explanation for low income is that the graduate dropped out of the labor market to have children; most income-contingent loan plans, including Clinton's, base the repayment obligation on the joint income of a married couple.<sup>205</sup>)

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202. By contrast, in determining "need" for eligibility for grants or subsidized student loans, the federal government considers various nontaxed resources of the borrower or the family, including child support, welfare, tax-exempt bond interest, untaxed pension and social security benefits, and tax-deductible contributions to individual retirement accounts. 20 U.S.C.A. § 1087vv(a)-(b) (West Supp. 1994).

203. JOHNSTONE, *supra* note 45, at 104; *see also* MCPHERSON & SCHAPIRO, *supra* note 42, at 182 n.39 ("It is worth noting that policies which subsidize the preparation of people to enter 'underserved' occupations tend to suppress wages in those professions by adding to the supply.").

204. President William J. Clinton, Radio Address to the Nation (May 1, 1993), *available in* LEXIS, NEWS Library, REUTRN File.

205. *See* JOHNSTONE, *supra* note 45, at 93-97 (discussing the problem of the female graduate's "negative dowry," while properly noting that the "charge, however, is peculiar neither to income contingency nor to women"); Student Loan Reform Act of 1993, 20 U.S.C.A. § 1087e(e) (West Supp. 1994). For married taxpayers, this new law requires repayment as a percentage of *joint* adjusted gross income; what happens if both spouses are repaying income contingent debt? The Yale plan based repayment on the borrower's own income, or *one-half* of joint income if higher. While the new law applies to the borrower's income alone, the study called for in the statute urges that consideration be given for "adequate treatment of marriage," including "no excessive marriage penalties or subsidies, no ability to avoid payment by shifting income between spouses,

Yale University operated a mutualized program in the 1970s, styled a "Tuition Postponement Option" (or "TPO").<sup>206</sup> The university created the program "when finances caused the administration to raise the term bill without offering an accompanying increase in conventional financial aid levels. . . . Later payments would be less burdensome than with conventional loans because repayment would be over a longer period and payment amounts would be contingent on income level."<sup>207</sup> Simply put, this means that Yale formalized

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equal payments for couples with equal joint income and borrowing, and fair allocation of a later payment between two spouses' accounts (in case of later divorce)." OBRA Conference Report, *supra* note 32, at 467-68. It is mathematically impossible to simultaneously satisfy the first and third of these conditions. See Bittker, *supra* note 69, at 1396 ("we cannot simultaneously have (a) progression, (b) equal taxes on equal-income couples, and (c) a marriage-neutral tax burden").

206. A total of 3602 students participated, and 718 (19.9%) repaid their obligations in full by June 7, 1993. Letter from Arthur A. Gallagher, Yale University Associate Bursar, to Evelyn Brody (June 7, 1993) (on file with author).

Yale obtained a ruling from the Internal Revenue Service blessing the favorable tax consequences of every aspect of the plan. Rev. Rul. 72-2, 1972-1 C.B. 19; see Yale Univ. Office of Student Loan Accounting and Collections, Questions and Answers, Question 9 (1988) (prepared for distribution to Tuition Postponement Plan participants) (on file with author). Not only were interest payments tax-deductible under the law then in effect, but also Rev. Rul. 72-2, at 20, allowed the allocation of payments first entirely to principal. This ensured that by the time the graduate got around to paying interest, he or she was in a really high tax bracket and could best benefit from the interest deduction. Indeed, Yale determined that the 1986 Tax Reform Act's repeal of the consumer interest deduction "led 280 to 300 borrowers to buy out of TPO." Yale Univ. Office of Financial Aid, Tuition Postponement Option (1988) (on file with author) [hereinafter Tuition Postponement Option]. Yale's ruling for frontloading principal repayments wound up double-harming its TPO participants: They lost the deductions before 1986 to the extent they were characterizing interest as principal and they lost the postponed amounts after repeal of the interest deduction.

Not clear about the Yale plan (as a mutualized plan) is whether the "winners" can now claim that "excess" payments are not interest at all but rather qualify as charitable contributions to a type of "deferred scholarship fund" for the benefit of the low earners in the pool. Cf. JOHNSTONE, *supra* note 45, at 175. Such an argument has no merit. The excess payments really represent "losing" the lottery by succeeding in the job market, and just like any other insurance premium must be characterized *ex ante*. Cf. Gail Jordan Hupper, Note, *Moral Obligation Financial Aid Programs: A Section 170 Analysis*, 84 COLUM. L. REV. 1402, 1402 (1984) (discussing students who receive financial aid awards "on the condition that he or she undertake a nonbinding obligation to transfer a like amount to the school at some later date").

207. Rena Cheskis, Yale Univ. Office of Institutional Research, Rep. No. R00184, The Yale Tuition Postponement Option Loan Experience 1 (1984) (on file with author) [hereinafter Yale TPO Experience]. In 1976, Yale terminated the TPO program, which was available to all students regardless of financial resources, but Yale also operated a companion program for financially needy students only, the "Contingent Repayment Option" (CRO), from 1974, until 1980. *Id.* at 1, 6. (For simplicity, I refer simply to TPO, although the needs-based requirement of CRO raises all the issues already discussed.) Yale terminated TPO ostensibly because the Middle Income Student Assistance Act of

shifting more of the higher education costs to the students themselves, recognizing that the students will be able to repay out of future income.<sup>208</sup>

Under the Yale plan, upon finishing schooling a borrower joined a pool of all others finishing at the same time. Each group had the obligation to repay the amount borrowed, plus Yale's cost of borrowing and an administrative fee. Twice a year each member made payments equal to a modest percentage of income. A member could exit the group early, upon repaying 150 percent of the amount borrowed. The group as a whole would terminate no later than thirty-five years after formation (this date represented the borrowed amount divided by the minimum required payment, so that, barring default, no borrower escaped liability for at least the principal). According to a 1984 study conducted by the university, the complexities of TPO baffled the borrowers.<sup>209</sup>

In an externally subsidized program, the sponsor bears the costs of underpayment; *once you define the interest rate*,<sup>210</sup> there is no risk to any particular borrower of doing better than average. By contrast, the promoter of a mutualized program worries about adverse selection — the disinclination of those who expect to be high earners to participate. A market-run insurance scheme avoids adverse selection by "risk rating" according to "statistically predictable earnings potential."<sup>211</sup> However, this technique, observes Professor Johnstone, would be "both politically impossible and ethically indefensible" for a university or governmental lender.<sup>212</sup>

Consequently, forced cross-subsidization works only to the extent you can compel participation from the subsidizers. The Yale TPO imposed income-contingent repayment as a condition to making the loan.<sup>213</sup> Thus, those students who expected to be wealthier could still

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1978 extended subsidized guaranteed student loan eligibility to all income classes. Tuition Postponement Option, *supra* note 206. However, after Congress removed the subsidy for higher-income borrowers in 1981, *supra* note 179, Yale did not reinstate the program.

208. The time-honored ad hoc method for successful students to pay more for their schooling is through later (generally tax-deductible) charitable contributions. *See, e.g.*, Stephan, *supra* note 62, at 1373 (calling these donations "deferred" tuition).

209. *See* Yale TPO Experience, *supra* note 207, at 4 ("Less than half of all survey participants indicated that they understood how an individual or a repayment group completed repayment. To these fifty percent, TPO/CRO must seem to be a never-ending obligation.").

210. *See* discussion of whether the Clinton plan is mutualized or externally subsidized, *infra* notes 216-21 and accompanying text.

211. JOHNSTONE, *supra* note 45, at 112.

212. *Id.*

213. Yale TPO Experience, *supra* note 207, at 6. Accordingly, "approximately 34 percent of all Freshmen in 1971-1972 took TPO, 53 percent of aid students, and 13 percent of non-aid students." *Id.* This leads one to wonder whether greater access to funding merely leads to tuition inflation (the "Bennett hypothesis," named after William E. Bennett, Secretary of Education under President Reagan). MCPHERSON & SCHAPIRO, *supra* note 42, at 72, rebut the argument "that private institutions increase their tuitions



opt out by paying for their college education with cash or borrowings from other sources. Yet the high cost at some of the Yale schools appeared to balance the low income prospects of graduates from other schools: "a Divinity student may have been encouraged to take an income-contingent loan because of his likelihood of earning a low income, while TPO/CRO may have been the only loan option left for Medical students."<sup>214</sup>

In the absence of forced participation, a mutualized income-contingent loan proposal could succeed only if the pooled group were homogeneous in carrying more or less the same *expected* income stream.<sup>215</sup> Individual bad luck is typically what we are willing to insure against; moreover, if the general economy goes south, those who were doing well are as likely as the others to suffer a diminution in income (the base on which payments are measured).

Is the Clinton plan mutualized or externally subsidized? Those who reach the end of the maximum repayment term (25 years) are excused from any remaining unpaid principal or interest.<sup>216</sup> In effect, this functions as a scholarship in reverse. That is, the government might want to make outright grants to low-income students, but, beyond a narrow range of those clearly in need, it cannot predict *ex ante* who will be low-income measured over the long term. Accordingly, the government waits a substantial period of time until the graduate has reached the middle (and likely peak) of the life cycle of earnings before making the determination.<sup>217</sup> The plan contains no cross-subsidization feature, insists the Secretary of Education: "When high-income borrowers fully repay their loans, they stop paying."<sup>218</sup>

But is it true that income-contingent repayers with high incomes

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when they receive more federal student aid," although underpriced state institutions "tend to raise tuition by \$50 for every \$100 increase in federal student aid." *Id.*

214. Yale TPO Experience, *supra* note 207, at 7.

215. *Cf.* JOHNSTONE, *supra* note 45, at 112-13. "If students cannot be risk-rated by the lender, they will almost certainly, if allowed, risk-rate themselves." *Id.* at 112.

216. OBRA Conference Report, *supra* note 32, at 447.

217. In order to maintain parity with up-front grants, Congress would need to provide that any amounts forgiven will be excluded from income to the extent he or she would have qualified for section 117 relief (scholarships). Because the record keeping burden might be horrendous and it is likely that the borrower will have repaid a good portion of the borrowed principal by the time the loan is forgiven, Congress might as well assume that any uncollected principal does not exceed the eligible section 117 amount.

218. Richard W. Riley, *The Student-Loan Plan Deserves Better Marks*, BUS. WK., July 12, 1993, at 7, 7 (letter to the editor).

do not cover any of the costs of borrowers with lower incomes? Congress seems to want it both ways. In the statutory language, the interest rate formulas for each borrower are determined at the outset, when the borrower qualifies under one of the subsidized or unsubsidized programs. Thus, the rate does not depend on the eventual repayment method selected. However, the description of repayment plans under the bill stated: “[T]o the extent possible, the cost to the Federal Government for each cohort of borrowers does not exceed what such cost would be if all borrowers in the cohort selected the standard repayment plan.”<sup>219</sup> Because of the certain adverse selection that will occur should the cohort of income-contingent repayers be mutualized, the government cannot effectively maintain the same interest rate for that pool as for those repaying under the standard (or extended) fixed-interest methods.

To conclude that the Clinton program is externally subsidized is actually to say that taxpayers pick up the tab for the insurance feature. Indeed, a taxpaying low-income non-borrower (perhaps someone who even did not go to college) subsidizes a low-income borrower earning the same (or higher) income. Why shouldn’t we deal with the adverse selection problem by imposing market interest rates on all student loan borrowers? After all, the fact that the borrower rejects the income-contingent repayment option plan would usually imply that she has already decided that she won (lost?) the income lottery. Nevertheless, the government fronted her finances at the outset. Observe that more adverse selection can occur the more time we allow the borrower to make the choice between a conventional loan and an income-contingent one: an entering freshman might harbor hopes of being a nurse, but by the time she starts repaying her loan, she might have studied to be a brain surgeon.

This is not to say that the government should convert *all* of its financial aid resources from grants to market-rate loans. A genuinely low income graduate could suffer “debt overhang” for many years, limiting her access to credit for other worthy purposes. I strongly advocate using our collective resources for grants to give a boost to the disadvantaged — I just do not want the subsidy to go in the other direction. As described in this article, though, if we cannot develop better procedures to determine who is genuinely low-income we should at least limit subsidized interest rates to the small class of borrowers who would be unduly burdened repaying market interest

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219. 139 CONG. REC. S5622-23 (1993).

rates out of future income over the very long periods allowed in Clinton's program.<sup>220</sup> We can then preserve a fairer redistributive function for government by better targeting outright grants, subsidized loans, or higher loans caps.<sup>221</sup>

### E. Administration of a Governmental Income-Contingent Loan Program

#### 1. Direct Lending

Separate from the repayment methods described above, President Clinton obtained a radical restructuring in the way these loans are issued and administered: from the current federal *guarantee* of third-party loans<sup>222</sup> to *direct* lending by the federal government.<sup>223</sup> Third-

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220. Indeed, the Conference Report urges consideration of whether "the combination of IRS collection and an income-dependent repayment option provides an opportunity further to streamline student loan programs and to target subsidies more fairly based on the ability to repay loans, which can be determined by post-school income." OBRA Conference Report, *supra* note 32, at 468.

221. Indeed, perhaps our current subsidies do not go far enough. For example, federally guaranteed students loans typically may not be made in an amount greater than the student's out-of-pocket costs of attending school (including living expenses). In those rare cases where the parents depend on the child's earnings had she not gone to college, the family should be permitted to borrow additional amounts.

222. In moving to a direct loan program, the Clinton Administration took on the powerful banking industry and the secondary market makers, notably Sallie Mae. To provide a liquid market for student loans, the federal government established the Student Loan Marketing Association, a privately owned corporation, in 1972. With money it raises by selling debt, Sallie Mae buys student loans that were issued by private lenders. Sallie Mae "maintains a maturity structure of its debt that closely duplicates the short-term interest rate structures of its assets. . . . Because of the guarantee and the matching of the maturity structures of its assets and its liabilities, the activities of Sallie Mae are practically devoid of any credit risk or interest rate risk." BOSWORTH ET AL., *supra* note 164, at 143-44. Don't cry for Sallie Mae. In the Senate it succeeded in halving Clinton's proposal for 100% federal loan origination by 1998. *See also, e.g.*, Dean Foust, *Sallie Mae: Still a Big Woman on Campus?*, BUS. WK., Nov. 15, 1993, at 160; Maggie Mahar, *How Sallie Mae Will Survive*, BARRON'S, June 14, 1993, at 10. Sallie Mae also fought to preserve its role by announcing that it would reduce the interest rate by two percentage points for graduates making timely payments for the first 48 months — for loans issued after the start of 1993 that are subsequently sold to Sallie Mae, or for loans already in the hands of Sallie Mae that the borrower begins to repay after July 1, 1993. *See* Glenn Burkins, *Timely Payments Can Earn Reward; Incentive for Student Loans Tests Idea*, ARIZ. REPUBLIC, Nov. 21, 1993, at H2; *College Loan Rate Cut for Prompt Payers*, CHI. TRIB., Dec. 1, 1992, § 1, at 11.

223. Congress provided for phased-in direct lending, beginning with 5% of loans made in 1994-95, 40% in 1995-96, 50% in 1996-97 and in 1997-98, and 60% beginning in the 1998 academic year. OBRA 1993, *supra* note 8, at 342-43. An experimental direct-lending pilot program was already scheduled to begin in 1994. Higher Education Amendments of 1992, Pub. L. No. 102-325, § 451(a), 106 Stat. 448, 569 (1992) (Federal Direct Loan Demonstration Program); 58 Fed. Reg. 36,088 (1993) (to be codified at

party lending has served two distinct functions: It left to the private sector a large portion of the origination, servicing, and collections functions, and, under federal budget rules in effect until recent reforms, the program appeared to cost the government less than direct outlays of loan proceeds. While the second consideration no longer holds, it is still fair to ask whether the atrophied Department of Education can handle the extensive monitoring that would be required by direct lending, with its extended and complex proposed repayment schedules.<sup>224</sup> If it wished to retain the guarantee role rather than convert the federal role to direct lending, Congress could likely save origination and in-payment costs by reducing the subsidies paid to the lenders, and forcing the banks to share some of the cost of reducing defaults.<sup>225</sup> Further, the more flexible proposed repayment options give the government the opportunity to impose market-rate

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34 C.F.R. pt. 685) (effective date pending) (preamble to final regulations) ("These regulations are being published under unusual circumstances" given that "passage of the Student Loan Reform Act in some form seems likely."). On November 15, 1993, the Department of Education named 105 colleges and universities that will issue 5% of new student loans in 1994-95; 1,100 institutions applied, of which 900 met the eligibility requirements. *See At 105 Colleges, A Cheaper Student Loan*, N.Y. TIMES, Nov. 16, 1993, at A24.

224. *See, e.g.*, GENERAL ACCOUNTING OFFICE, PUB. NO. GAO/AIMD-93-04, FINANCIAL AUDIT: FEDERAL FAMILY EDUCATION LOAN PROGRAM'S FINANCIAL STATEMENTS FOR FISCAL YEAR 1992 (1993). Because of the Education Department's error-riddled database, inadequate financial reporting processes and procedures, and weak internal controls, the Department underestimates the costs of the current program by almost \$1.5 billion a year, calling into question whether the savings anticipated by the direct lending proposal could be fully realized. *Id.*; *see also* GENERAL ACCOUNTING OFFICE, PUB. NO. GAO/AIMD-93-33, FINANCIAL MANAGEMENT: EDUCATION'S STUDENT LOAN PROGRAM CONTROLS OVER LENDERS NEED IMPROVEMENT (1993). Additionally:

Sallie Mae's lobbying strategy is to paint herself as the model of private sector efficiency — phones are answered in ten seconds, bills and dunning notices fly out the door, computers are state-of-the-art — except for those old, obsolete tape drives which Sallie Mae needs to communicate with the Department of Education.

*Sallie Mae Is Fighting for Its Life* (CNN television broadcast, May 24, 1993), available in LEXIS, NEWS Library, CNN File, Transcript # 317-2; *cf.* Eglin, *supra* note 171, at 56. Loan information submitted electronically by the guarantee agencies to the Education Department "is then stored in a database nicknamed the 'tape dump.' This mass of unverified, sometimes incomplete, data is the only national database on the Stafford program," resulting in the government's losing tens of millions of dollars on new loans made to students already in default on old loans.). Critics of Clinton's plan also pointed to the Federally Insured Student Loan Program (FISL), replaced by the current system, as a failed experiment in direct lending. *See, e.g.*, Perry D. Quick, *Shaky Plan for Student Loans*, CHRISTIAN SCI. MONITOR, June 29, 1993, at 18 ("Neither the GAO nor the administration has given us reason to believe that a new direct government loan system would not fizzle like its predecessor.").

225. While the federal government reimburses guarantee agencies at less than 100% if their default percentages get too high, the current system perversely also pays a 30% bounty for collecting defaulted loans — thus inducing the guarantee agencies to let the loan slide into default before undertaking enforcement efforts. *See* Mary Jordan, *Student Loan System Faulted; Debt Collectors' Conflicts Threaten Program*, HILL TOLD, WASH. POST, June 19, 1993, at A2 (at a cost of \$26 million, the federal government in 1990 bailed out one guarantee agency, the Higher Education Assistance Foundation

interest requirements on a greater range of borrowers, thus saving more money.

Retaining third-party lending but permitting income-contingent repayments, however, would prove difficult. A pilot project permitting income-contingent repayment under the current third-party lending system appeared in a vetoed tax bill from March, 1992,<sup>226</sup> but Sallie Mae's president "could offer only a vague description of how such a plan might work."<sup>227</sup> A third-party lender would demand an intolerably high level of interest from all borrowers (or from the federal government) to cover the risk of income shortfall from a particular borrower, not just because the loan is long-lived, but because it bears an uncertain income stream.<sup>228</sup> In other words, with government issuance, the government can subsidize (or not) borrowers as and when they make income-contingent payments, rather than anticipate and fund an estimated shortfall with a likely expensive interest factor.

## 2. Complexity and Burden of Income-Contingent Repayment

The Clinton administration expects about fifteen percent of direct student loan borrowers to choose the income-contingent repayment

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("HEAF"), which "had many conflicts of interest with spinoff companies that were helping it collect student debts"); *see also* GENERAL ACCOUNTING OFFICE, PUB. NO. GAO/HRD-93-12BR, GUARANTY AGENCY SOLVENCY: CAN THE GOVERNMENT RECOVER HEAF'S FIRST-YEAR LIQUIDATION COST OF \$212 MILLION? 3 (1992) ("For example, assume that the Department [of Education] reimbursed an agency for a \$100 defaulted loan at the 80-percent rate and the agency subsequently collected \$100 from the borrower. First the agency retains the \$20 for which it was not reimbursed. Then the agency retains \$30 . . . to offset collection costs. . . ."); *cf.* Becker, *supra* note 188, at 18 ("The solution is not to eliminate banks and their experience but to require them to bear a larger share of the cost of their bad student loans. Banks covet the student loan business. When the default rate on a bank's student loans increases, it should have to pay a higher insurance premium."). OBRA 1993, *supra* note 8, slightly shifts some of the default burden to the guaranty agencies. *See* OBRA Conference Report, *supra* note 32, at 464-65 (100%/90%/80% reimbursement rates reduced to 98%/88%/78%).

226. H.R. 4210, 102d Cong., 2d Sess. § 1003 (1992).

227. Matthew Morrissey, *Banking on Students*, NAT'L J., Feb. 6, 1993, at 339, 342 ("And in interviews, Consumer Bankers Association president Joseph Belew and [Philip] Corwin of the American Bankers Association were not enthusiastic about the idea."). The New England Education Loan Marketing Corporation ("Nellie Mae"), another guaranty agency, issued a paper urging instead: "Private industry can also collect repayment of loans over an extended period with appropriate consideration given to a student's income level through graduated or stepped repayment plans which will readily accommodate 95% of all borrowers and allow for individualized treatment of borrowers needing more flexible terms." O'Toole, *supra* note 171, at 3.

228. JOHNSTONE, *supra* note 45, at 155-56, 160.

option.<sup>229</sup>

An income-contingent loan imposes heavy administrative burdens on borrower and creditor alike. Compliance difficulties are only increased by the youth and inexperience of the debtor. "[F]ew students understand the effect of compound interest over time," observed Professor Johnstone; "they are often shocked at the large total dollar amounts involved in long-term loans, and express a preference for shorter repayment schedules and larger annual payments, even though their general willingness to borrow reveals a strong preference for present as opposed to future income."<sup>230</sup>

As mentioned above, Yale found high levels of misunderstanding among TPO borrowers. Ironically, in a 1984 survey, those in "default" (defined as having missed a payment) "indicate that one reason for . . . entering into default has been their desire no longer to receive nor to give support to others in their repayment group."<sup>231</sup> This general suspicion of a loan with unconventional terms required Yale to engage in heavy counseling of borrowers, over the very long repayment period of the loan.<sup>232</sup>

An easy way to avoid complexity is to adopt a graduated, but fixed, series of annual payment limits; the borrower pays the stated amount unless it exceeds his income-contingent percentage. Such a schedule could, for example, require an annual payment of, say, \$250 in the first three years, \$350 in the next three years, and \$500 each year thereafter, unless four percent of adjusted gross income were lower in any year. Thus, for "the majority of payments . . . incomes would have to be neither reported by the borrower nor monitored by the lender."<sup>233</sup> This would sweep away the underbrush

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229. *Full Implementation of Direct Student Loans May Be Delayed*, Sen. Kennedy Says, BNA's BANKING REP., May 31, 1993, at 791, available in LEXIS, NEWS Library, BNABNK File (quoting Deputy Education Secretary Kunin).

230. JOHNSTONE, *supra* note 45, at 46. Even in prepared testimony, students reveal their lack of understanding of how interest works. See *Hearing on S. 2255*, *supra* note 197, at 94 (Statement of the United States Student Association) ("She will have to pay \$8,362 for a \$4,000 loan. It's crazy that poor people are expected to pay twice as much for their education!"). Indeed, a poor borrower might have an even higher discount rate than a wealthy borrower.

231. Yale TPO Experience, *supra* note 207, at 5.

232. Tuition Postponement Option, *supra* note 206, at 1; see also Yale TPO Experience, *supra* note 207, at 4; cf. *Hearing on S. 2255*, *supra* note 197, at 95 (Statement of the United States Student Association) ("Where are students supposed to turn to for counseling and information on their student loan repayment options and problems? The IRS? . . . Will the IRS or the Department of Education provide counseling?"); *Hearing on H.R. 2336*, *supra* note 197, at 80 (statement of Michael S. Bigelow, Deputy Assistant Commissioner, Returns Processing, Internal Revenue Service) ("[T]here would be a tremendous impact on Taxpayer Service sites and service centers which would have to respond to inquiries on these notices each year during our busiest season.").

233. JOHNSTONE, *supra* note 45, at 124. Professor Johnstone adds: "Unless some arrangement were made to have income contingent loans collected along with taxes by the Internal Revenue Service, fixed schedule payments should be cheaper to collect and

of small loan balances, while offering the income insurance desired by the borrower.<sup>234</sup> Additionally, we might expect some borrowers to choose income-contingent repayment for only their first few years in the workforce, and then revert to a shorter-term, fixed-dollar method after their incomes rise.<sup>235</sup>

Finally, because we would be throwing the most complex loan terms at those who by definition have the lowest income prospects, we should consider wiser use of outright grants for those likely to realize low incomes for a significant period of time.<sup>236</sup>

### 3. IRS's Role in Administration

In introducing his direct lending proposal, President Clinton thundered:

[M]y proposal is to have a direct line from the government that you have to pay back after you go to work at tax time. So, you can't beat the bill. You can't — if you're earning income and you're in the tax system, you must pay it back. You can't beat it. We'll have a . . . loan default rate that will be about the same rate as the tax evasion rate which is a lot lower than the student loan evasion rate, right?<sup>237</sup>

Clinton sought to use the Internal Revenue Service to collect loans in income-contingent repayment status; some members of Congress would like to use the Service to collect all direct student loans. As we will see below, switching to direct lending need not alone require

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less subject to underpayment or default." *Id.* As I discuss below, this mechanism would equally benefit the IRS as collector.

234. See Yale TPO Experience, *supra* note 207, at 5 ("TPO/CRO is a long term loan, and has been metaphorically compared to taking out a mortgage on one's education. Yet, unlike a mortgage . . . a main attraction of TPO/CRO was the relatively small financial burden. . . . [A] majority of both defaulters and non-defaulters would prefer, instead, a shorter repayment scheme with more moderate payments.").

235. *Cf. id.* at 10 ("[W]hile we hope that students will remain appreciative of their Alma Mater over time, borrowers say that they resent being financially tied to an educational institution for a twenty-to-thirty year period.").

236. See, e.g., Ann Coles, *The Dilemmas of Loan Counseling: A Practitioner Viewpoint*, in STUDENT LOANS: RISKS AND REALITIES, *supra* note 11, at 56, 56 ("Women comprise two-thirds of the borrowers who have to commit more than 10 percent of their income to student loans. [Of borrowers devoting this high a percentage to loans], 80 percent were single, and many of those single borrowers had dependent children.").

237. Address by President-Elect Bill Clinton at Wilbur Wright Community College, Chicago, Illinois, *supra* note 26; cf. James D. Gordon III, *Interplanetary Intelligence About Promissory Notes as Securities*, 69 TEX. L. REV. 383, 401 n.145 (1990) ("[T]he government can protect itself by withholding wages to recover student loan payments. For example, if you graduate with a Ph.D. in Renaissance Literature, every week the government could withhold some of the tips you earn as a waiter."). The percentage of students defaulting fell to 17.5% of borrowers in 1991. *U.S. Student Loan Default Rate Drops in FY 1991*, *supra* note 171. The "tax gap" is harder to pin down.

Internal Revenue Service involvement. However, offering an income-contingent repayment mechanism makes at least some IRS participation inevitable.<sup>238</sup>

As a threshold matter, we should recognize that, even in the case of income-contingent repayment, this does not necessarily require that the Internal Revenue Service actually collect student loans.<sup>239</sup> As long as Congress gives the Service the ability to share tax return information, private bill collectors could be informed of the borrowers' adjusted gross income. As discussed below, private bill collectors might be even more nimble than the Service in collecting these obligations. Finally, it is hard to imagine that wage withholding offers superior convenience to borrowers than, say, automatic payment from checking accounts, and wage withholding is certainly more burdensome to employers.

When originally introduced in the Senate education committee, Clinton's proposal contemplated an Internal Revenue Service collection function. To avoid turf battles with the Capitol Hill tax-writing committees, however, the conferees finally just requested the Secretaries of Education and Treasury to study the feasibility of IRS collection.<sup>240</sup> Congress gave the Department of Education access only "in establishing the income-contingent repayment amount" (and this disclosure authority expires in five years).<sup>241</sup> The conference bill dropped a new section 6306 of the Code, passed by the Senate, which would have permitted the President to implement repayment of federal direct student loans through wage withholding or other means. This proposal would have provided that these amounts would be treated as "additional income taxes due," and would have required the Secretary of the Treasury to establish any necessary procedures and conventions, including:<sup>242</sup>

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238. For the demonstration program of direct lending, "the Secretary does not anticipate that the IRS will be involved in the actual loan collection process through payroll deductions." 58 Fed. Reg. 36,088, 36,092 (1993) (to be codified at 34 C.F.R. § 685) (effective date pending) (preamble to final regulations).

239. *Hearing on H.R. 2336, supra* note 197, at 75 (statement of Michael S. Bigelow, Deputy Assistant Commissioner, Returns Processing, Internal Revenue Service) ("Congress and the Administration must ultimately make the policy decision whether IRS should become the collection agent for all federal debts.").

240. OBRA Conference Report, *supra* note 32, at 466. This study, still not published as of September 1994, was due six months after the August 1993 enactment of the bill, in time to implement its recommendations in 1994, when very limited direct student lending will begin. Note that this contemplated use of the Internal Revenue Service extends beyond income contingent loans, the collection of which obviously requires access to tax return information.

241. *See id.* at 279-81.

242. The following wording appears in House Bill 2264 section 12055(e), creating new Internal Revenue Code section 6306; slightly different wording appears in House Bill 2264 section 12011, adding new section 457 to 20 U.S.C. section 1087a (the Higher Education Act of 1965).



- (1) procedures for disputes to be resolved through the Secretary of Education;<sup>243</sup>
- (2) an alternate system of fees and penalties (not to include IRS seizure of real property), for the nonpayment of amounts due;<sup>244</sup> and
- (3) provisions related to withholding, payment of estimated tax, and allocation of payments.<sup>245</sup>

Instead, the managers of the conference "reaffirm that IRS collection of student loans should be explored"<sup>246</sup> and that the principles of an earlier proposal by Congressman Petri<sup>247</sup> "provide a useful guide to that exploration."<sup>248</sup> The conferees then set out numerous principles, some of them inconsistent with earlier versions of the bill, and some of them inconsistent with each other. Among these are that "IRS collection should be as convenient as possible for borrowers";<sup>249</sup> "it should impose no additional burden on employers";<sup>250</sup> and to minimize the burden on the IRS, "it should conform as closely as possible to the operations of the IRS in collecting the regular individual income tax, self employment tax, and social security taxes on tip income."<sup>251</sup> In pondering this assignment, the Treasury and Education Departments will have to resolve many questions, among them:

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243. Presumably student loan borrowers cannot contest their liability in the Tax Court. *Cf.* H.R. REP. NO. 461, 102d Cong., 2d Sess., pt. 2 (1992) (conference report to H.R. 4210) (passed Mar. 20, 1992; vetoed the same day) ("Self-Reliance Loans" proposal required borrower to appeal errors to the Department of Education, whose "decisions will be reviewable by the appropriate district court as a final agency determination").

244. If the loan repayment obligations constitute "taxes" a host of broad IRS remedies would kick in. In addition, a tax liability on a joint return can be satisfied from either spouse, whereas under state law (except community property states) a student loan is generally a separate obligation of the borrower. The Service's powers of "shoot first, ask questions later" evidently provided an unacceptably low level of due process for student loan defaulters. The Senate obviously felt that the interest rate and penalties imposed on underpayments of tax would likely be higher than those desired by the Department of Education for loan defaults.

245. However, the vetoed March 1992 Self-Reliance Loan proposal contemplated that the Treasury "will determine the liability of borrowers for incorrect withholding according to rules on estimated tax payments." H.R. REP. NO. 461, *supra* note 243. Treating contingent loan repayments as taxes would also increase the burden on employers, who must make deposits of withheld taxes on a regular basis, the frequency of which depends on the amounts collected. *Hearing on H.R. 2336, supra* note 197, at 89-90 (statement of Michael S. Bigelow, Deputy Assistant Commissioner, Returns Processing, Internal Revenue Service).

246. OBRA Conference Report, *supra* note 32, at 467.

247. *Id.*

248. *Id.*

249. *Id.*

250. *Id.*

251. *Id.*

i. *How do we determine the required payment?*

Unless the repayment schedule adopts the income ceiling proposal discussed above, each borrower will be able to calculate his additional "tax" only with great difficulty. (It's hard enough just doing your taxes once a year.<sup>252</sup>) This means either basing the percentage on *last* year's income, or waiving penalties for underpayment of tax.<sup>253</sup> In either case, if a borrower does not adjust wage withholding or make estimated tax payments, the liability can seem invisible, and appear overwhelming when it shows up in a lump sum on April 15 each year.<sup>254</sup> Self-employed taxpayers create additional problems (often free from third-party reporting, they are already our least

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252. The IRS would have to find a way to squeeze another line onto the Form 1040, which "is much easier said than done." *Hearing on H.R. 2336, supra* note 197, at 78 (statement of Michael S. Bigelow, Deputy Assistant Commissioner, Returns Processing, Internal Revenue Service) ("In addition to changing the form and instructions, we would need to re-write software, design new processing routines in the service centers, train staff . . . , account for money collected with the returns, and inform and advise taxpayers . . . ."); see also *Miscellaneous Tax Bills and the Peace Tax Fund: Hearing Before the Subcomm. on Select Revenue Measures of the Comm. on Ways and Means House of Representatives on H.R. 65 What Can I Do for America Act, H.R. 1733 to Exempt from Income Tax Certain Common Investment Funds, and H.R. 1870 United States Peace Tax Fund*, 102d Cong., 2d Sess. 68 (1992) (statement of Terrill A. Hyde, Tax Legislative Counsel, Department of the Treasury), *statement available in* LEXIS, FEDTAX Library, TNT File as 92 TNT 108-39 (opposing proposal to add voluntary check-offs to the tax return). Hyde explained:

Space on the income tax form is already allocated to maximize compliance. Mandating additional items displaces items crucial to the proper reporting and collection of tax. It can be expected that tax receipts relating to the dropped items will suffer. It is possible that voluntary contributions to federal programs pursuant to this bill will not compensate for the lost tax revenue from reduced compliance in these other areas.

*Id.*

253. Compare the March 1992 Self-Reliance Loan proposal: "Not later than January 31 of each calendar year, the Secretary of Education will certify to each borrower the amount of interest and principal paid on such loans for the second preceding calendar year." H.R. REP. NO. 461, *supra* note 243, at 335.

254. Nellie Mae also emphasizes the unique burdens that loan repayment through wage withholding would impose on employers (regardless of income-contingent repayment). First, "each student's (employee's) education loan debt would be different, some \$5,000, some \$7,500, some \$25,000. Thus, verification and calculation requirements would differ by employee as opposed to a set percentage of FICA taxes being applied to each employee equally." O'Toole, *supra* note 171, at 4. Second, "recordkeeping [would] be cumulative and transferable. An employer would have to keep track of amortizing student loan debt for as long as 20 years or more and provisions [would] have to be created to transfer to subsequent or multiple employers a student loan repayment history." *Id.* Proponents of IRS collection argue, however, that the employer need never know why the employee is simply requesting an additional amount of taxes withheld (a request that employers already must honor), and that the recordkeeping on the loan balance is simply a matter between the borrower and the IRS at tax time on the Form 1040.

compliant sector<sup>255</sup>). Married borrowers raise unique issues of fairness, as they do generally under our progressive income tax.<sup>256</sup>

*ii. How do we allocate tax payments throughout the year to the loan?*

Desiring "payments" to be due any more often than annually raises not just "stacking order" issues of when payments of interest and principal are considered made, but the more fundamental issue of determining the amount of interest accruing on the remaining principal.<sup>257</sup> Finally, from the Service's viewpoint, should there be an understatement of "actual" tax liability for the year, the Service will want amounts collected to be treated as actual taxes rather than as loan repayments to be allocated to the Department of Education.

*iii. Will the Service have to adopt special collection procedures?*

Congress has already given the Internal Revenue Service the authority to offset tax refunds against debts due the federal government, including defaulted student loans.<sup>258</sup> It is a peculiar statute — all the debtor has to do is reduce withholding to create a balance-due tax return — but it is easy to administer. The Service conducted four studies showing that taxpayers at risk of losing refunds not only reduced withholding but further, in some cases, simply stopped filing.<sup>259</sup> By contrast, Congress's auditing arm, the General Accounting Office, found these effects to be short-lived, and "that the revenue from increased debt collection will outweigh any decline in revenue

255. See, e.g., 1992 IRS ANN. REP. (Pub. 55, May 1, 1993) ("we believe the most important challenges to our system of tax administration come from those who fail to . . . report self-employment income accurately"); GENERAL ACCOUNTING OFFICE, PUB. NO. GAO/HRD-92-108, TAX ADMINISTRATION: APPROACHES FOR IMPROVING INDEPENDENT CONTRACTOR COMPLIANCE I (1992) ("As early as 1979, we concluded that non-compliance among self-employed workers, such as independent contractors, was serious enough to warrant some form of tax withholding on payments to them.").

256. See *supra* note 205.

257. Cf. H.R. REP. NO. 461, *supra* note 243, at 334 ("Repayment tax payments received on or before the due date . . . for filing of the income tax return for a given taxable year are credited to the taxpayer's Self-Reliance Loan account as if received on the last day of the previous taxable year"; similarly, payments received later are treated "as if received on the last day of the following taxable year.").

258. Enacted in 1984, the experiment will sunset in 1994 unless Congress is satisfied that program does not adversely affect tax compliance. See GENERAL ACCOUNTING OFFICE, PUB. NO. GAO/GGD-91-64, TAX POLICY: REFUND OFFSET PROGRAM BENEFITS APPEAR TO EXCEED COSTS (1991). Congress also gave the IRS authority to offset refunds against child support obligations. *Id.*

259. *Id.*

from taxpayer noncompliance.”<sup>260</sup>

The General Accounting Office, however, recently criticized the Internal Revenue Service for following “a lengthy and rigid three-stage collection process that begins with a series of written notices, or bills, sent to delinquent taxpayers over a period of about 6 months, followed by telephone calls, and ends with visits to delinquent taxpayers.”<sup>261</sup> Further, Congress prohibited the agency from sharing tax return information with private bill collectors, and from evaluating or rewarding its staff on the basis of collection results.<sup>262</sup> By contrast, “many state tax departments and private sector collectors” make effective use of early telephone contact, employ private collectors, and use performance bonuses to motivate staff.<sup>263</sup> The GAO recommends legislative and administrative changes to allow the Service to compete with other bill collectors and state governments for payments from debtors who likely have insufficient assets to cover all their liabilities.<sup>264</sup>

Accordingly, contrary to popular perception, the Internal Revenue Service is particularly unsuited to collecting these relatively small amounts. In the first place, as described in part I.C, a taxpayer need not even file if her gross income is less than her personal exemption plus the standard deduction — will loan obligations count as part of this tax liability threshold?<sup>265</sup> Even for uncontested tax liabilities,

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260. *Id.*

261. GENERAL ACCOUNTING OFFICE, PUB. NO. GAO/GGD-93-67, TAX ADMINISTRATION: NEW DELINQUENT TAX COLLECTION METHODS FOR IRS 1 (1993).

262. *Id.*

263. *Id.*

264. Saddled with high expectations yet hamstrung by congressionally imposed restrictions, the IRS must secretly envy private bill collectors. Consider the following account given of a private child support collection:

“They not only harassed me . . . they tried to irritate me by constantly saying things that are not true,” [the father] said. “They called my job several times, threatening my accountant at work.

“When I called them back to explain, they automatically said I was lying. They said I was scum.”

Drake [the collector] says he wants deadbeat parents to feel uncomfortable.

“It takes a lot of work to extract money out of these guys,” he said. “These guys in my opinion are criminals. They’re stealing from their own kids.”

Vivian Marino, *Run For the Money*, CHI. TRIB., June 30, 1993, § 6, at 1, 15.

265. Low-income borrowers who file anyway in order to claim the earned income tax credit might use the refundable portion to pay down student debt. *See, e.g.*, Guy Gugliotta, *How to Aid ‘Working Poor’? Tax Credit Serves as Lifeline but Has Its Critics*, WASH. POST, Apr. 15, 1993, at A1 (“The IRS has used [one borrower’s] EITC (\$2,200 over the last two years) to pay down student loans that she has used in her quest to become a child psychologist. She will probably achieve her goal, thanks, in part, to the EITC.”); *cf.*, 138 CONG. REC. H1914-16 (daily ed. Mar. 26, 1992) (proposed amendment to the Higher Education Amendments Act of 1992, that would prevent offsetting tax refunds by, or collecting, defaulted student loans “unless the net income of the student borrower and the borrower’s spouse, including any cash benefits received under a needs-based government assistance program, exceeds 150% of the poverty level for the size of the family which the student borrower has”); *see also* H.R. REP. NO. 461, *supra*

the Service uses a dollar threshold below which it forbears collection.<sup>266</sup> For obvious reasons, the agency keeps this amount secret; nevertheless it likely exceeds all but the largest student loan balances.<sup>267</sup>

### CONCLUSION

A college education is a unique human capital investment. It "pays off" for most students, and continues to pay off over their lifetimes. However, college can also be enormously expensive, which blocks access for those whose parents do not have the current means to finance it. Private lenders will not lend against future income. Until very recently, the federal government remedied this market failure exclusively by guaranteeing repayment of student loans issued by private lenders. Beginning in July 1994, in a legislative victory for President Clinton, the federal government began to make "direct" student loans, scheduled to reach sixty percent of new student loan volume by 1998. Direct lending will also allow the government to offer the student a novel repayment option: the graduate can elect to repay the principal and interest out of a modest percentage of his or her future income. The Internal Revenue Service would take on a new role in collecting income-contingent repayments.

Clinton's plan, however, perpetuates existing federal subsidies in our current guaranteed student loan program, and thereby misses an opportunity to apply analyses based on intergenerational equity and lifetime income to reform these subsidies. We currently pay an interest subsidy on behalf of all but high-income families. Once we recognize that the cost of a college education can generally be matched to its profits, a percentage-of-income repayment cap on student loans is the only real insurance most graduates need against doing poorly in

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note 243, at 334 ("No repayment for a Self-Reliance Loan is required in any year in which the borrower is not required to file an income tax return."); OBRA Conference Report, *supra* note 32, at 467 (same). On the other hand, requiring filing by student loan borrowers would bring more people into the system, and reduce the Service's general "nonfiler" problem.

266. GENERAL ACCOUNTING OFFICE, *supra* note 261.

267. *Cf. Hearing on H.R. 2336, supra* note 197, at 82 (Statement of Michael S. Bigelow, Deputy Assistant Commissioner, Returns Processing, Internal Revenue Service) ("Based on a review of the payment amounts in the charts accompanying Mr. Petri's bill, we conclude that many of the delinquent student loan cases would not be assigned a high enough priority under our current rating system and therefore would receive only routine attention;" thus, while the cases would receive several notices "and could result in levy action, they most likely would not be worked by Revenue Officers making personal contact.").

the job market. Abandoning a broad financial needs test based on the parents' financial status would free up scarce communal resources to be devoted where they can really make a difference: to assist those from chronically disadvantaged families.

What can we learn from this governmental lending model? Future research can examine whether a direct government role could or should be employed for other major early life cycle expenditures on human capital — such as child care, health care, and even elementary and secondary education. For example, if we view the financial burden of day care (which often falls on young, low-earning families) only as one of timing, could we convert our tax expenditures into loans to working parents that they could repay over many years through payroll withholding?<sup>268</sup> Besides the policy and administrative questions raised in this article, these other applications would confront us with the following issues: Do we want an increased federal role for what have traditionally been considered state or local decisions?<sup>269</sup> Are the amounts involved large enough to bear the compliance and enforcement costs? How do we deal with the moral hazard issues that plague even the best insurance schemes, resulting in inefficient borrowing? How do we ensure that the money we save on providing services to the middle- and upper-class gets channeled to helping the truly needy?

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268. Cf. Barbara Presley Noble, *Financing Strategies for Child Care*, N.Y. TIMES, June 20, 1993, § 3, at 25 (four states have established child-care loan guarantee funds — for loans to the care providers, not to the parents) (reviewing RICHARD C. FERLAUTO ET AL., CENTER FOR POLICY ALTERNATIVES, *THE CHILD CARE CREDIT CRUNCH: A SURVEY OF LENDING FOR CHILD CARE FACILITIES* (1993)).

269. In particular, were we to “privatize” elementary and secondary schooling, how would we instill our common democratic values and other training in citizenship?